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Securities industry developments - 2003/04; Audit risk alerts

American Institute of Certified Public Accountants. Auditing Standards Division

AUDIT RISK ALERTS

Securities Industry Developments — 2003/04

Strengthening Audit Integrity
Safeguarding Financial Reporting

American Institute of Certified Public Accountants

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Notice To Readers

This Audit Risk Alert is intended to provide auditors of financial statements of broker-dealers in securities with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. Because securities broker-dealers often deal in commodity futures or function as commodity pool operators, this Audit Risk Alert expands the discussion of recent developments to include matters that may affect the audits of commodity entities as well.

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Accounting and Auditing Publications

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Securities Industry Developments—2003/04

How This Alert Helps You

This Audit Risk Alert helps you plan and perform the audits of your securities industry clients. The knowledge delivered by this Alert assists you in achieving a more robust understanding of your client's business and economic environment. This Alert is an important tool in helping you identify the significant risks that may result in the material misstatement of your client's financial statements. Moreover, this Alert delivers information about emerging practice issues and current accounting, auditing, and regulatory developments.

If you understand what is happening in the securities industry and can interpret and add value to that information, you will be able to offer valuable service and advice to your clients. This Alert assists you in making considerable strides in gaining that industry knowledge and understanding it.

This Alert is intended to be used in conjunction with the AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk).

Economic and Industry Developments

See the AICPA general *Audit Risk Alert—2003/04* for a discussion of the U.S. economic and business environment.

Positive Outlook for the Securities Industry

Gains in Key Market Indices

The stock market registered strong gains this year. As of the end of the third quarter of 2003, the Dow Jones Industrial Average (DJIA) increased 27 percent from the record low it reached last October and is up 11 percent for the year to date. The National

Association of Securities Dealers Automated Quotation (NASDAQ) Composite Index was up 60 percent from last October's low while showing a 34 percent gain for the year so far. And the Standard & Poor's 500 stock index (S&P 500) increased 28 percent since last October and 13 percent for the year to date. Barring any unexpected negative developments, 2003 may become the stock market's first up year since 1999. Investors who moved out of stocks during the market downturn are pulling back into the market, further stimulating the recovery.

Improved Profitability

The securities industry is expected to post record profits in 2003 as revenues continue to improve and the benefits of several years of cost-cutting finally pay off. Underwriting revenue for the year is expected to be 27 percent higher than last year's results. So far, the growth has come mostly from debt underwriting, but stock underwriting also picked up in the third quarter.

Business was not so good in the most profitable areas, such as initial public offerings (IPOs) and mergers and acquisitions (M&As). With a record low of only 10 companies going public during the first two quarters of 2003 and just 24 more companies completing deals in the third quarter, the amount of money that was raised in this market during the first nine months was almost 65 percent less than what was raised during the same period a year ago. However, the backlog of companies planning to go public increased by 46 in the third quarter, raising hopes that the IPO market is improving.

M&A activity remained significantly below last year's levels; however, there are signs of improvement on a quarter-by-quarter basis. Based on the increased level of deal discussions, some analysts believe that the M&A market will pick up soon. The outlook for the next year is also positive, with expectations for further increases in industry profitability.

Proprietary Trading

A trend worth mentioning is the increase in proprietary trading. To compensate for the decline in revenues in the most profitable areas, such as IPO underwriting and M&A advisory work, the securities industry had to find other ways to make money. A number of companies decided to expand trading with their own capital, referred to as proprietary or firm trading. These companies increased trading activity in their own accounts by investing in stocks, bonds, commodities, currencies, and derivative products indexed to those items, as well as interest rates. Fixed-income operations were very profitable this year and companies that traded bonds for their proprietary accounts reaped huge rewards. However, critics caution that this strategy is very risky because if the firm bets the wrong way, losses can be substantial. Supporters contend that the high margins that can be achieved through proprietary trading are worth the risk. There are a number of audit-related issues that need to be considered in connection with proprietary trading. See the "Auditing Considerations Related to Proprietary Trading" section of the Alert for a detailed discussion of different types of proprietary trading and related auditing considerations.

Major Developments at the NYSE

Over the past year, the New York Stock Exchange (NYSE) went through one of the most difficult periods in its 211-year history. Trading practices of some of its elite specialists were investigated, its chairman was forced to resign due to a public outcry following disclosures about the size of his compensation package, and its governance structure and integrity have been questioned.

One of the first actions of the new interim chairman of the Big Board was to order a top-to-bottom review of the exchange's governance. A key issue to be addressed in this review is whether to retain the compensation and corporate governance committees or eliminate them and allow the whole board to assume these functions. The exchange will also consider the need to split the chairman and chief executive positions. While reviewing its own governance structure, the Big Board is also likely to reconsider the corporate governance rules it proposed last year for its listed companies. These rules were proposed in an effort to boost investor confidence in the U.S. financial system following the collapse of Enron, WorldCom, and other companies. In the existing proposal, the NYSE recommended that its listed companies establish audit, compensation, and corporate governance committees. This arrangement would mirror the current NYSE structure, which has been blamed for many of the exchange's recent problems.

Dealing With the Issue of Self-Regulation

The scandal over the chairman's compensation raised serious questions about the future of self-regulation at the NYSE. Of the NYSE board's 27 members, 12 are representatives of the securities industry, which is regulated by the exchange. Critics of the existing system say there are inherent conflicts of interest in this arrangement, allowing the regulated to set the pay of the regulator and have significant input on how they are regulated.

In November 2003, New York Stock Exchange members approved governance changes proposed by the NYSE's interim chairman that call for a scaled-down independent board to oversee regulation and governance. The proposal also calls for the establishment of an advisory panel that would include representatives of the securities industry. This plan still needs to be approved by the Securities Exchange Commission (SEC). Some critics say this proposal is not adequate and call for a complete separation of the Big Board's regulatory arm. The SEC chairman is leaning toward a more moderate approach that would allow the Big Board to continue to regulate its members but would require significant changes to its governance structure to ensure the independence of the regulatory function from business considerations.

When testifying before a Senate subcommittee on market structure issues, the SEC chairman said the principle of self-regulation is based on the idea that regulation is best accomplished as close as possible to the regulated activity. However, a self-regulatory organization that operates a market has an inherent conflict of interest between its roles as a market and as a regulator. The SEC is currently reviewing the self-regulatory structure and governance practices of the nation's stock exchanges. Some believe that to solve the governance problems, the exchange has to become public, a move that would force it to adhere to the more strict governance and reporting standards promulgated for public companies. If the exchange were to proceed with this plan, it would be forced to split its regulatory arm as part of an IPO.

Human or Computer?

The future of the Big Board as one of the last remaining human-dominated exchanges is also being debated. Taking advantage of technological developments, most exchanges have replaced human traders with matchmaking software. However, at the NYSE, each order still goes through a specialist who matches buyers and sellers. When there are no matching orders, specialists step in with their own money to facilitate trading. Specialists are allowed to trade for their own accounts, but they can do so only when there are imbalances between buy and sell orders. Otherwise, they are supposed to step out of the way.

Proponents of the existing system argue that the use of specialists helps to keep trading orderly and fair, while critics say the system is subject to manipulation. Critics cite the joint NYSE and SEC investigation into whether some specialists profited from trading for their own accounts by stepping between buyers and sellers as an example of the system's vulnerability to abuse. Recently, the NYSE announced that the specialists involved in the investigation will face disciplinary action for improper trading and may have to reimburse investors between $100 million and $150 million for potential losses, as well as pay significant fines. This investigation may be even more damaging for the NYSE than for the specialists involved. It gives ammunition to critics of the existing auction system that uses human traders, and raises questions about the exchange's ability to regulate its members as well as the future of self-regulation.

Regulatory and Governance Changes Likely

The scandals that rocked the NYSE this year are likely to result in significant governance changes. The future of self-regulation is still unclear. There is a chance that the NYSE may lose some or all of its regulatory powers. If this were to happen, it would have serious consequences for the securities industry. As an auditor of a broker-dealer, you should closely follow further developments in this area to ensure that you have a good understanding of the business environment in which your client operates.

Research Analyst Conflicts of Interest

Global Settlement

On April 28, 2003, the SEC, the New York State Attorney General's Office, the North American Securities Administrators Association (NASAA), the National Association of Securities Dealers (NASD), the NYSE, and state securities regulators announced that enforcement actions against 10 of the nation's top investment firms involving conflicts of interest between research and investment banking had been completed, thereby finalizing the global settlement reached and announced by regulators in December 2002. The enforcement actions allege that, from approximately mid-1999 through mid-2001 or later, the firms engaged in acts and practices that created or maintained inappropriate influence by investment banking over research analysts, thereby imposing conflicts of interest on research analysts that the firms failed to manage in an adequate or appropriate manner. In addition, the regulators found supervisory deficiencies at every firm.

Pursuant to the enforcement actions, the 10 firms are required to pay penalties of $487.5 million, disgorge $387.5 million, pay $432.5 million to fund independent research, and pay $80 million to fund investor education. The total of all payments is roughly $1.4 billion. The settlement requires that the federal portions of the penalties and the disgorgement be deposited into distribution funds to help compensate investors who purchased equity securities identified in the complaints against the firms and who lost money on those investments. The penalties imposed under this settlement rank among the highest—and, in the case of one firm, the single highest penalty—ever paid in a civil securities enforcement action. Also, under the terms of the settlement, the firms may not treat these penalties as tax deductible or seek reimbursement for them from an insurance carrier or other third party.

In addition to the monetary payments, the firms are required to comply with significant requirements that dramatically reform their practices, including separating their research and investment banking departments, how research is reviewed and supervised, and making independent research available to investors. Among the changes that the firms are required to make are the following:

- To ensure that stock recommendations are not tainted by efforts to obtain investment banking fees, the settlement requires research analysts to be insulated from investment banking pressure. The firms are required to sever the links between research and investment banking, including prohibiting analysts from receiving compensation for investment banking activities and prohibiting analysts' involvement in investment banking "pitches" and "roadshows." Among the more important reforms:

  – The firms have to physically separate their research and investment banking departments to prevent the flow of information between the two groups.

  – The settlement requires the firms' senior management to determine the research department's budget without input from investment banking and without regard to specific revenues derived from investment banking.

  – Research analysts' compensation may not be based, directly or indirectly, on investment banking revenues or input from investment banking personnel, and investment bankers may not have any role in evaluating analysts' job performance.

  – Research management is responsible for making all company-specific decisions to terminate coverage, and investment bankers may not have any role in company-specific coverage decisions.

  – Research analysts are prohibited from participating in efforts to solicit investment banking business, including pitches and roadshows. During the offering period for an investment banking transaction, research analysts may not participate in roadshows or other efforts to market the transaction.

  - The firms are required to create and enforce firewalls restricting interaction between investment banking and research, except in specifically designated circumstances.

- To ensure that individual investors get access to objective investment advice, the firms are obligated to furnish independent research. For a five-year period, each of the firms is required to contract with no fewer than three independent research firms that will make available independent research to the firm's customers. An independent consultant for each firm will have final authority over the procurement of independent research.

- The settlement calls for enhanced disclosures, including a disclosure on the first page of each research report stating that the firm "does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the firm may have a conflict of interest that could affect the objectivity of this report."

- To enable investors to evaluate and compare the performance of analysts, the settlement requires disclosure of research analysts' historical ratings. Each firm has to make its analysts' historical ratings and price target forecasts publicly available.

In addition to the other restrictions and requirements imposed by the enforcement actions, the 10 firms have collectively entered into a voluntary agreement restricting allocations of securities in "hot" IPOs to corporate executives who could direct investment banking business to a firm, a practice known as "spinning." This will promote fairness in the allocation of IPO shares and prevent firms from using these shares to attract investment banking business.

The scope and the applicability of the global settlement to securities firms other than the ones that signed on to the deal are still being debated. However, regulators say that the deal should put the entire securities industry on notice. According to the New York State Attorney General, institutions, even if they are not signatories to the deal, should be building structures that abide by the pact. In September 2003, the International Organization of Securities Commissions endorsed some of the terms of the U.S. Global Settlement by issuing recommendations that research analysts not be allowed to assist in obtaining investment banking business or promote investment banking deals to investors. Even though these recommendations are nonbinding, they are expected to be adopted by a number of firms, thereby alleviating concerns of major U.S. investment banks with international presence that they would be subject to tougher rules than their foreign competitors.

In May of 2003, the Senate Banking Committee held a hearing to examine the adequacy of the global settlement. The lawmakers questioned the effectiveness of the existing self-regulatory system, which had failed to detect problems at the major securities firms for so long. They criticized the settlement for not going far enough to prevent future problems and stressed the need to hold individual executives accountable for their wrongdoings. As a result, in June, the NASD, the NYSE, and the SEC requested e-mails and other documents from more than 50 executives at 12 securities firms to determine the extent of their involvement in the research conflict cases.

Some consider the global settlement to be the biggest regulatory change to affect the securities industry since the deregulation of brokerage commissions in 1975. The names of the firms involved in this scandal have been tarnished and their reputation has been damaged. However, the research scandal is far from being over. Wall Street firms should brace themselves for an onslaught of investor lawsuits and arbitration actions citing recommendations of their analysts. While the securities firms involved neither denied nor admitted their guilt, regulators made available to the public e-mails and other documents uncovered during their investigation, thereby providing aggrieved investors and their lawyers with new evidence at almost no cost. The NASD expects that 3,000 to 4,000 cases involving research issues will be filed as a result of the settlement. Also, the fact that the settlement allows investors participating in the distribution funds to pursue any other remedy or recourse they may have is likely to encourage people to file separate private claims against the firms. Legal proceedings are hurting investment banks' profitability by forcing them to pay significant amounts in legal fees and settlements. As an auditor of a securities firm, you need to consider the impact of litigation on your client's financial statements. See the "Litigation, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Additional information on the global settlement can be obtained from the SEC Web site at www.sec.gov. Click on the Global Analyst Settlement link on the left side of the page.

SEC Rulemaking

Regulation AC. In February 2003, the SEC adopted new Regulation Analyst Certification (Regulation AC). Regulation AC requires that brokers, dealers, and certain persons associated with a broker or dealer include in research reports certifications by the research analyst that the views expressed in the report accurately reflect his or her personal views, and disclose whether or not the analyst received compensation or other payments in connection with his or her specific recommendations or views. Broker-dealers are also required to obtain periodic certifications by research analysts in connection with the analyst's public appearances. By requiring these certifications and disclosures, Regulation AC should promote the integrity of research reports and investor confidence in those reports. See the "SEC Regulations" section of this Alert for more information on Regulation AC and other recently issued SEC rules.

After issuance of Regulation AC, the SEC received numerous questions regarding the application of the new rules. To address these questions, in August 2003, the SEC released its Responses to Frequently Asked Questions Concerning Regulation Analyst Certification, which can be found on the SEC Web site at www.sec.gov.

Addressing the Problem of Retaliation Against Negative Analyst Reports. During the investigations into the conflicts of interest between research and investment banking, it became apparent that analysts feel pressure to issue positive research not only from their investment banking teams but also from the companies they cover. It is not uncommon for a corporation unhappy with a research report to cut off the analyst from information or call the analyst's supervisor and request his or her dismissal. To address the problem of corporate retaliation against analysts issuing negative research reports, in April 2003, the SEC sent a letter to the NYSE, the Nasdaq Stock Market, and the American Stock Exchange asking them to consider developing new rules to prevent this practice.

NASD and NYSE Rulemaking

On May 10, 2002, the SEC approved rule changes filed by the NYSE and NASD governing research analyst conflicts of interest. On July 30, 2002, President Bush signed into law the Sarbanes-Oxley Act of 2002 (the Act), which requires, among other things, that the SEC (or upon authorization and direction of the SEC, a registered securities association or national securities exchange) adopt rules governing analyst conflicts. Certain of the Act's mandates were satisfied by NASD and NYSE rule provisions existing at the time of its enactment. Other mandates of the Act necessitated amendments to the existing rules. The Act requires rules governing analyst conflicts of interest, including rules limiting the supervision and compensatory evaluation of securities analysts to certain officials, rules defining the periods during which brokers or dealers engaged in a public offering of a security as an underwriter or dealer may not publish research on such security, and rules requiring securities analysts and brokers or dealers to disclose specified conflicts of interest. In July 2003, the SEC approved NYSE and NASD proposed rule changes that further address research analyst conflicts of interest in connection with equity research reports, and are designed to achieve full compliance with the mandates of the Act. While the NASD and NYSE rules may differ to some degree in their texts, the provisions are intended to operate in substantially the same way. See the "Self-Regulatory Organization Regulations" section of this Alert for more information on these rule changes.

Mutual Fund Breakpoints

Last year, after NASD routine examinations, securities regulators became concerned that investors who purchased Class A shares of mutual funds were not always receiving breakpoint discounts. Mutual funds sold through broker-dealers may include a sales charge (also called a "load"), which compensates the broker-dealer selling the fund's shares. Mutual funds with front-end sales loads often offer investors the opportunity for a reduction in sales loads as the dollar value of the shares purchased by an investor or a member of his/her family increases. The levels at which the front-end sales charge is reduced are determined by the mutual funds and are generally termed "breakpoints." Although breakpoint discounts are offered by mutual funds, much of the responsibility for calculating the proper discounts falls on brokerage firms that sell the funds.

In December 2002, the NASD issued *Special Notice to Members 02-85* directing each of its member firms that sell mutual fund shares to immediately review the adequacy of its policies and procedures to ensure that they are designed and implemented so that investors are charged the correct sales loads on mutual fund transactions. This notice to members also stated that broker-dealers must: (1) understand the breakpoint discounts offered by mutual funds; (2) ascertain the information that should be recorded on their own books and records to allow them to provide all available discounts, such as qualifying prior or prospective transactions of a particular customer; (3) apprise each customer of the discount opportunities and inquire about other qualifying holdings that might entitle the customer to receive a discount; and (4) correctly process the transaction so that the customer receives the applicable discount. On the same date, the SEC sent a letter to brokerage firms stressing the importance of this issue.

Between November 2002 and January 2003, the SEC, NASD, and the NYSE conducted an examination sweep of 43 registered broker-dealers that sell mutual funds with a front-end sales load to determine their ability to provide breakpoint discounts. In March 2003, the regulators issued the report *Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds* (Joint Report), which summarizes the results of these examinations, conclusions, and remedial actions. According to the Joint Report, most of the 43 broker-dealers examined failed to provide the appropriate breakpoint discount to customers in a significant number of cases. The group of firms examined in the sweep did not provide breakpoints in about 32 percent of the transactions that were eligible for a discount, and the average discount not provided was $364 per transaction. The Joint Report, however, notes that many of the problems did not appear to be intentional failures to charge correct sales loads.

In March 2003, NASD asked some of its member firms to conduct a self-assessment of their record of providing investors with breakpoint discounts. A preliminary analysis of data obtained through this self-assessment showed that most firms did not uniformly deliver appropriate breakpoint discounts.

NASD Recommendations to Fix the Breakpoint Problem

On July 22, 2003, the NASD issued *Report of the Joint NASD/ Industry Task Force on Breakpoints*, which recommends a number of operational enhancements, disclosure requirements, and regulatory changes in response to problems in delivering breakpoint discounts to investors purchasing mutual fund shares with front-end loads. The recommendations contained in this report will affect virtually every level of the mutual fund distribution chain, including broker-dealers that sell mutual funds, the mutual funds themselves, and the transfer agents that administer mutual fund accounts. The report recommends that mutual fund companies take steps to make investors aware of the availability of breakpoint discounts; that broker-dealers adopt policies and practices to gather the appropriate information from investors so that they can take advantage of all available breakpoint discounts; that transfer agents and broker-dealers modify the systems used to execute mutual fund transactions; and that regulators, such as NASD, NYSE, and the SEC, and the mutual fund and securities industries continue to take active measures to educate the investing public about breakpoint opportunities. The Joint NASD/Industry Task Force also recommended that the SEC staff revisit its April 18, 1979, No-Action Letter, which permits brokerage firms to omit sales charge information from confirmations sent to investors who purchase mutual funds charging loads. Such information is required for most other types of investments.

Firms Are Obligated to Pay Refunds to Customers

Because the practice was so widespread, the NASD ordered industrywide refunds to investors. In its Notice to Members 03-47, *Refunds to Customers Who Did Not Receive Appropriate Breakpoint Discounts in Connection with the Purchase of Class A Shares of Front-End Load Mutual Funds and the Capital Treatment of Refund Liability*, the NASD provides guidelines for firms to follow when calculating refunds to customers and accounting for their anticipated refund liabilities. (Subsequently, NASD added to its Web site under *Ask NASD* a "Frequently Asked Questions" discussion of the requirements addressed in Notice to Members 03-47.) The Notice to Members provides that firms must take prompt and immediate action to provide refunds to customers. Failure to provide such refunds will subject firms to disciplinary action, separate and apart from any disciplinary actions that may result from the initial failure to deliver breakpoint discounts. Furthermore, firms must treat their refund obligations as liabilities on their financial statements and must ensure that they are operating in net capital compliance after accounting for these liabilities. Firms must also take appropriate actions to segregate and protect the funds necessary to satisfy their refund liability.

The NASD stresses that firms need to consider the requirements of Financial Accounting Standards Board (FASB) Statement of Financial Accounting Concepts No. 6, *Elements of Financial Statements*, when accounting for their refund liability. Concept No. 6 specifically recognizes that the amount of a liability does not need to be certain before it is recorded. Accordingly, approximations and estimates may be used to record a liability. Thus, firms must determine their probable liability based upon currently available information in accordance with Concept No. 6 and generally accepted accounting principles (GAAP). The NASD also issued a notice to members as to the amount of refund they should be providing to customers, and brokers are either to record this amount or statistically justify another amount. In either case, the amount should be reserved for in the customer reserve (SEC Rule 15c3-3) until it is either paid or a period of time has elapsed in which customers can claim it.

On November 3, 2003, the SEC and NASD announced a series of actions in connection with overcharges to customers on their mutual fund purchases. NASD directed almost 450 securities firms to notify customers who had purchased Class A mutual fund shares since January 1, 1999, that they may be due refunds as a result of the firms' failure to provide breakpoint discounts. NASD also directed almost 175 firms with poor records of providing breakpoint discounts to complete a comprehensive review of transactions since the beginning of 2001 for possible missed discount opportunities; a number of those firms may be the subject of enforcement actions by NASD and the SEC. NASD estimates that at least $86 million is owed to investors for 2001 and 2002 alone. Therefore, refunds may be material to financial statements of some brokerage firms. As an auditor of securities firms that sell mutual funds with front-end loads, you may need to determine that your clients properly account for refund liabilities and comply with other NASD requirements to avoid penalties.

Mutual Fund Sales Practices

Class B Shares

Over the past several years, regulators have brought a number of enforcement actions dealing with mutual fund sales practices. A significant portion of those cases have involved allegations of unsuitable sales of Class B shares of mutual funds. In multiclass mutual funds, different classes of shares are characterized by the type and amount of fees charged to investors. Class A shares carry a front-end sales charge but they usually also offer breakpoint discounts (discussed above), which in some cases could reduce commissions paid by investors. Class B shares do not have front-end loads, but they have higher ongoing expenses and contingent deferred sales charges.

When recommending multiclass mutual funds to customers, a broker has a responsibility to analyze costs associated with various classes of mutual fund shares with the objective of finding the most appropriate type of investment for the client. A broker's recommendations should be based on what is in the best interest of the client, not his or her own profit considerations. According to regulators, this is not always the case. This year, the NASD brought several enforcement actions against securities firms alleging that brokers violated NASD's suitability rule by recommending purchases of large volumes of B shares instead of A shares. According to the NASD, the purchase of A shares would have eliminated or reduced front-end sales charges through breakpoint discounts available at various dollar amounts; in addition, the purchase of A shares would have resulted in lower ongoing expenses than those available through B shares and avoided the contingent deferred sales charges associated with B shares.

The SEC sanctioned a major securities firm for having inadequate systems in place to effectively monitor and enforce its policies and procedures relating to sales of different classes of mutual funds. Owing to the inadequacy of those systems, one of the brokers formerly employed by the firm had, on numerous occasions, sold his customers large volumes of Class B shares without disclosing the existence of multiple classes of shares within the same fund and of breakpoint discounts available with the purchase of Class A shares of the same funds. The SEC also alleges that the firm and its brokers stood to make more money through sales of Class B shares than they would from sales of Class A shares.

Preferential Treatment of Certain Funds

Regulators also focused this year on sales of proprietary mutual funds. In September, the NASD censured and fined a major securities firm for conducting prohibited sales contests for its brokers and managers to promote sales of proprietary funds. These contests violated NASD conduct rules because they favored the firm's in-house funds. Sales contests are not prohibited if they are for an entire class of product; for example, total sales of mutual funds regardless of the funds' affiliation are permitted. The NASD also charged that the firm failed to have any supervisory systems or procedures in place to detect and prevent this widespread misconduct. By providing additional incentives for selling in-house mutual funds, the firm subjugated its customers' needs to the financial interest of its brokers. The SEC is also considering enforcement actions against this firm.

The SEC launched a fact-finding study concerning conflicts of interest in mutual fund investments. The commission will investigate whether brokerage firms sold mutual funds to investors because of their own profit considerations rather than investor needs. The SEC requested detailed information from a number of securities firms regarding broker pay and sales practices. Among other things, the SEC is investigating arrangements between brokerage firms and fund companies under which brokers agree to promote the fund company's products in exchange for the fund company directing its trading activity to the brokerage firm. The SEC is examining more than 15 brokerage firms to determine whether brokers' recommendations to their clients were improperly influenced by these arrangements.

To address these issues, on August 7, 2003, the NASD proposed for comment a rule that would require securities firms to expand their disclosures of two types of compensation paid for the sale of mutual fund shares. The first type of compensation consists of cash payments to brokerage firms in return for a place on a list of funds that a firm most commonly offers, referred to as "shelf space." The second is the payment of a higher compensation rate to individual brokers for selling certain funds. Such disclosures should help investors realize that brokerage firms may have financial incentives to recommend particular funds. According to the NASD, the proposal would require firms to disclose the nature of certain compensation arrangements in writing when the customer first opens an account or purchases mutual fund shares. The proposal also would require member firms to update this information twice a year and make it available on their Web sites.

The proposed amendments would require a securities firm to disclose: (1) that information regarding a fund's fees and expenses may be found in the fund's prospectus; (2) that the fund's policies regarding selection of securities firms (such as soft dollar and directed brokerage arrangements) are described in the fund's statement of additional information, which an investor may request; (3) if applicable, that the member receives cash payments from mutual funds and their affiliates other than the fees disclosed in a fund's prospectus fee table, and the nature of this compensation; (4) a list of mutual fund firms that made these payments to the firm in descending order based upon the total amount of compensation received from each firm; and (5) if applicable, that registered representatives receive different rates of compensation for different investment company products, the nature of these arrangements, and the names of the investment companies favored by these arrangements. The SEC is also expected to consider additional regulation in this area.

In addition to being the focus of various regulatory agencies concerning their mutual fund sales practices, brokerage firms face a number of investor lawsuits. Also, in some of the cases discussed above, regulators alleged that brokerage firms did not have proper supervisory systems to prevent and detect misconduct. Failure on the part of securities firms to supervise their employees opens them up to significant legal exposure. As an auditor of securities firms, you need to consider the impact of litigation on your client's financial statements. See the "Litigations, Claims, and Assessments" section of this Alert for a further discussion of this topic.

Mutual Fund Late Trading and Market Timing

On September 3, 2003, the New York State Attorney General filed a complaint alleging the existence of illegal trading schemes that cost mutual fund investors billions of dollars annually. This investigation focuses on two types of trading practices known as late trading and market timing. According to the complaint, late trading involves purchasing mutual fund shares at the 4:00 p.m. price after the market closes. Late trading is prohibited by the New York Martin Act and SEC regulations because it allows a favored investor to take advantage of post-market-closing events not reflected in the share price set at the close of the market. Market timing is an investment technique involving short-term, "in and out" trading of mutual fund shares that has a detrimental effect on long-term shareholders. The technique is designed to exploit market inefficiencies when the net asset value, or NAV, price of the mutual fund shares—which is set at the 4:00 p.m. market close—does not reflect the current market value of the stocks held by the mutual fund. When a "market timer" buys mutual fund shares at the stale NAV, it realizes a profit when it sells those shares the next trading day or thereafter. That profit dilutes the value of shares held by long-term investors. Market timing is not illegal but is considered improper when a mutual fund's prospectus says that the practice is discouraged or prohibited.

In the beginning of the investigation, regulators focused mostly on hedge funds that did improper trades and on mutual funds that allowed the trades to happen. However, shortly after the New York State Attorney General's investigation was made public, major securities firms received requests for information from the SEC asking, among other things, about their largest customers involved in mutual fund trading and their largest clients in terms of revenues. The SEC also asked whether the securities firms or their employees allowed clients to engage in late trading and market timing strategies. According to Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, brokers "have an obligation, just like mutual funds, under the federal securities laws to process mutual-fund shares appropriately. …They have to say these are the orders that were received before 4 o'clock and these were the orders received after 4 o'clock."

Industry and Rulemaking Initiatives

On September 10, 2003, the Securities Industry Association (SIA) sent a letter to its member firms reminding them of their mutual fund compliance obligations. In this letter, the SIA asked its members to review and ensure their compliance with all relevant rules and regulations regarding the handling of mutual fund orders and to undertake a prompt review of their policies and procedures in that regard. The letter also stressed the importance of the comments by SEC Enforcement Director Stephen Cutler, who said that the industry has "an opportunity to get ahead of the curve by addressing the problems that now exist… Doing so will put you in a far better position from a regulatory perspective…" Even though brokerage firms that executed the orders were not named in the New York Attorney General's complaint, most of them are taking the investigation very seriously and have begun to examine their own practices related to handling mutual fund orders to determine if any improprieties have taken place. Some of those investigations resulted in suspension or dismissal of several brokers.

On October 9, 2003, the SEC chairman announced a number of rulemaking initiatives to eliminate or minimize the possibility of late trading and market timing abuses. In preparing one possible amendment, the SEC staff is examining the feasibility of requiring that the fund (rather than an intermediary such as a broker-dealer or other unregulated third party) receive the order prior to the time the fund prices its shares in order for an investor to receive that day's price. For most funds, this would mean that the fund would have to receive the order by approximately 4:00 p.m. for the investor to receive that day's price. This would effectively eliminate the potential for late trading through intermediaries that sell fund shares. In December, the SEC is expected to vote on this proposal.

Auditing Considerations

Broker-dealers operate in a highly regulated industry that requires close attention to compliance matters. As an auditor of broker-dealers, you need to stay alert to regulatory and legislative developments to determine that your clients are in compliance with the regulations. Also, remember that if your broker-dealer client is being investigated by regulators, this fact may require disclosure.

Important Sarbanes-Oxley-Related Regulations for Auditors of Brokers and Dealers or Investment Advisers

Registration With PCAOB

Although the Sarbanes-Oxley Act is directed at "issuers" (as defined by the Act) and their auditors, privately held securities broker-dealers also come under the scope of certain provisions of the Act. This is because Section 205(c)(2) of the Act amended Section 17 (15 U.S.C. 78q) of the Securities Exchange Act of 1934 to require *all* broker-dealers (both public and private) to be audited by a public accounting firm registered with the Public Company Accounting Oversight Board (PCAOB). On August 4, 2003, the SEC deferred until January 1, 2005, the requirement that auditors of nonpublic broker-dealers register with the PCAOB (see Release No. 34-48281 at www.sec.gov and "Other Recent SEC Developments" section of this Alert for more information). Therefore, privately held broker-dealers could continue to file with the SEC and send their customers financial statements audited by "independent public accounting firms" (which may not be registered with the PCAOB) through that date or until the SEC decides otherwise.

Independence Rules

On January 28, 2003, the SEC adopted amendments to its existing requirements regarding auditor independence to enhance the independence of accountants who audit and review financial statements and prepare attestation reports filed with the SEC (see Release No. 33-8183 at www.sec.gov and the "SEC Regulations" section of this Alert for more information on these rules). On

August 13, the SEC's Office of the Chief Accountant provided responses to 35 frequently asked questions regarding the application of these rules. Practitioners with registered broker-dealer clients should take a moment to review these, since the last question, # 35, indicates that the scope of services provisions of Sarbanes-Oxley extend to auditors of privately held broker-dealers. Accordingly, auditors of privately held broker-dealers are restricted from performing those services specifically excluded by Sarbanes-Oxley and are expected to comply with all other SEC independence rules, including those that prohibit bookkeeping and the preparation of financial statements for privately held broker-dealers. However, as indicated by the response to question 35, the auditor rotation rules do not apply to auditors of private broker-dealers. SEC answers to frequently asked questions regarding the independence rules can be found at www.sec.gov/info/accountants/ocafaqaudind080703.htm.

Compliance and Supervisory Systems

In last year's Alert we discussed a high-profile broker fraud case in which a star broker misappropriated over $115 million from his customers over a 15-year period. To cover up his activities, he diverted clients' brokerage-account statements to third-party addresses or post office boxes he controlled and then sent his clients forged statements inflating the value of their holdings. What was special about this case was that the two securities firms where the broker was employed during this 15-year period did not discover his fraudulent activities until the perpetrator himself sent a letter to the Federal Bureau of Investigation describing in detail how he was able to execute his scam for so long. This case underscored a number of fundamental problems with the way some Wall Street firms monitor their brokers, especially top-producing ones. One of the reasons why the broker's activities were never discovered by the compliance departments in both firms was that, as a branch manager, he had helped supervise the top compliance executive in his office. The hesitancy of some securities firms to supervise their top-producing brokers and the low prestige associated with the compliance function are also to blame.

In August of 2003, the two firms involved in this scandal were fined $7.5 million by the SEC and the NYSE for failing to supervise the broker. Both firms settled a number of cases with the aggrieved customers by paying them back what was stolen from their accounts. Regulators said that the case was "one of the most egregious examples of misconduct in the securities industry."

Rulemaking Remedies

To address the problems highlighted by this case, the NYSE and the NASD proposed new rules to strengthen supervisory procedures and internal controls of securities firms. In August 2003, the regulators filed with the SEC amendments to the proposed rules that would require broker-dealers to perform annual independent verification and testing of their supervisory internal controls in order to verify overall compliance with applicable SEC and self-regulatory organization (SRO) rules and regulations. The independent verification and testing requirement would not apply to firms that do not conduct a public business, that have a capital requirement of $5,000 or less, or that employ 10 or fewer registered representatives. See SEC Releases No. 34-48298 and No. 34-48299 for more information.

In June 2003, the NASD proposed rule amendments that would require the chief executive officer and chief compliance officer of each member firm to jointly certify annually that the member firm has adequate compliance and supervisory policies and procedures in place. According to the NASD, the goal of this rule is to promote an enduring compliance culture within firms by elevating the status of the chief compliance officer and by compelling periodic and significant consultation between senior business and compliance personnel. See NASD Special Notice to Members 03-29 for more information. The NASD also issued Interpretive Material-3010-1, which is intended to clarify the goal and the scope of certification requirements.

In August, the NASD proposed rule amendments requiring securities firms to implement special supervisory procedures for brokers with a number of regulatory actions, customer complaints, or other incidents that may be cause for concern. The proposed amendments would require securities firms to adopt heightened supervision plans for registered brokers who, within the last five years, have had three or more customer complaints and arbitrations, three or more regulatory actions or investigations, or two or more terminations or internal firm reviews involving wrongdoing. Under the new guidance, supervisors would have to approve the plan in writing and acknowledge responsibility for the execution of the plan.

Auditing Considerations

As an auditor of brokers or dealers in securities (broker-dealers), you are required by the SEC to issue a report on your client's internal control describing any material inadequacies found to exist or to have existed since the date of the previous audit. Refer to SEC Rule 17a-5 and Statement on Auditing Standards (SAS) No. 60, *Communication of Internal Control Related Matters Noted in an Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 325), for more guidance on reports on internal control. Also be aware that failure on the part of securities firms to supervise their employees opens them up to significant legal exposure. As an auditor of securities firms, you need to consider the impact of litigation on your client's financial statements. See the "Litigations, Claims, and Assessments" section of this Alert for a further discussion of this topic. For a discussion of an auditor's responsibility with respect to fraud, see the "Consideration of Fraud" section of this Alert.

Mandatorily Redeemable Instruments

In May 2003, the FASB issued FASB Statement of Financial Accounting Standards No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity.* This Statement establishes standards for how an issuer classifies and measures certain financial instruments with characteristics of both liabilities and equity. It requires that an issuer classify a financial instrument that is within its scope as a liability (or an asset in some circumstances). Many of those instruments were previously classified as equity. This standard may have a significant impact on broker-dealers organized as a partnership, where the partnership agreement contains provisions obligating it to buy back equity upon a partner's death. In those cases where there is certainty that the partnership will redeem the partnership interests (a partner's death is a certainty), the partnership interests will have to be reclassified as liabilities under FASB Statement No. 150. As a result, some broker-dealers may not report any equity in their GAAP financial statements. However, regulators are considering whether to allow broker-dealers to add back such partnership interests when performing their net capital calculation, subject to certain restrictions.

In November 2003, the FASB issued FASB Staff Position (FSP) FAS 150-3, which defers the effective date of the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs (including FSP FAS 150-2) for nonpublic entities as follows: (a) until fiscal periods beginning after December 15, 2004 for instruments that are mandatorily redeemable on fixed dates and (b) indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. It should be pointed out that the deferral for mandatorily redeemable financial instruments of certain nonpublic entities does not apply to a company that is considered to be an SEC registrant, even when it meets the definition of a nonpublic entity in FASB Statement No. 150. For example, a company that is required to file financial statements with the SEC is considered to be an SEC registrant. In this case, therefore, nonpublic brokers will not get a deferral, as they are treated as SEC registrants. You can view this and other FSPs on the FASB Web site at http://www.fasb.org/fasb_staff_positions/final_fsp.shtml. Also refer to the "New Accounting Pronouncements and Other Guidance" section of this Alert, which discusses provisions of FASB Statement No. 150 in a greater detail.

Value of Exchange Memberships

During the past year, the value of U.S. exchange memberships has continued to fluctuate. In October 2003, the NYSE reported a sale of two seats for $1.35 million each, which is the lowest price in nearly five years. Although declines in the value of exchange memberships do not affect regulatory net capital, because exchange memberships are excluded from the net capital calculation, such declines continue to raise concerns about the value of such assets reported in financial statements prepared in accordance with GAAP.

As discussed in paragraph 5.141 of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide), the auditor should be satisfied concerning the propriety of the carrying value of a membership and whether the carrying value has been impaired. Paragraph 7.34 of the Guide states that exchange memberships owned by a broker-dealer and held for operating purposes should be valued at cost or at a lesser amount if there is an other-than-temporary impairment in value. AICPA and FASB staff are currently considering the accounting guidance for exchange memberships that is discussed in the Guide in light of the issuance of FASB Statement No. 142, *Goodwill and Other Intangible Assets*. The issue is whether an exchange membership is an intangible asset with indefinite life that should be measured under FASB Statement No. 142, or whether it is a long-lived asset that should be measured under FASB Statement No. 144, *Accounting for the Impairment or Disposal of Long-Lived Assets.* Readers should be alert to a final decision that may impact the accounting for exchange memberships.

Consolidated Supervision

In October 2003, the SEC proposed rule amendments and new rules under the Securities Exchange Act of 1934 that would establish two separate voluntary regulatory frameworks for the SEC to supervise broker-dealers and their affiliates on a consolidated basis. These proposals respond to international developments relating to firms that do business in the European Union (EU). These firms may need to demonstrate that they have consolidated supervision at the holding company level that is "equivalent" to EU consolidated supervision. The SEC believes that its supervision contemplated by these proposals would meet this standard. As a result, these proposals should minimize duplicative regulatory burdens on firms that are active in the EU, as well as in other jurisdictions that may have similar laws.

One proposal, *Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities*, would establish an alternative method to compute certain net capital charges for broker-dealers that are part of a holding company that manages risks on a group-wide basis and whose holding company consents to group-wide SEC supervision. This alternative method would be available to broker-dealers that maintain tentative net capital of at least $1 billion and net capital of at least $500 million. Big Wall Street firms with international presence are expected to benefit from this proposal, which, according to some estimates, would allow the largest firms to reduce the amount of capital they must set aside by half or even more. The broker-dealer's holding company and its affiliates, if subject to SEC supervision, would be referred to as a consolidated supervised entity (CSE).

The alternative method the broker-dealer would be allowed to use to compute certain market and credit risk capital charges would involve the use of internal mathematical models that the broker-dealer uses to measure its risk. The CSE would be required to comply with rules regarding its group-wide internal risk management control system and would have to periodically provide the SEC with consolidated computations of allowable capital and risk allowances consistent with the Basel Standards. The SEC supervision of the CSE would include recordkeeping, reporting, and examination requirements. Special provisions have been included with respect to functionally regulated affiliates. See SEC Release No. 34-48690 for more information on this proposal.

The other proposal, *Supervised Investment Bank Holding Companies*, would implement Section 17(i) of the Securities Exchange Act, which created a new structure for consolidated supervision of holding companies of broker-dealers, or investment bank holding companies (IBHCs), and their affiliates. This alternative would be available to smaller firms holding tentative net capital of $100 million or more. Pursuant to the Securities Exchange Act, an IBHC that meets certain specified criteria may voluntarily register with the SEC as a supervised investment bank holding company

(SIBHC) and be subject to supervision on a group-wide basis. These companies would continue to calculate net capital requirements using traditional methods. Pursuant to the proposed rules, registration as an SIBHC is limited to IBHCs that are not affiliated with certain types of banks and that have a substantial presence in the securities markets. The proposed rules would provide an IBHC with an application process to become supervised by the SEC as an SIBHC, and would establish regulatory requirements for those SIBHCs.

SEC supervision of an SIBHC would include recordkeeping, reporting, and examination requirements. Further, the SIBHC would be required to comply with rules regarding its group-wide internal risk management control system and would have to periodically provide the SEC with consolidated computations of allowable capital and risk allowances consistent with the Basel Standards. See SEC Release No. 34-48694 for more information on this proposal.

The proposals also include technical and conforming amendments to the risk assessment rules (Securities Exchange Act Rules 17h-1T and 17h-2T). In addition, the SIBHC proposal would adjust the audit requirements for over-the-counter derivative dealers to allow accountants to use agreed-upon procedures when conducting audits of risk management control systems.

The proposed rules were posted on the SEC Web site on October 24, 2003, and will be published in the *Federal Register* shortly. Comments must be received within 90 days after the date of publication in the *Federal Register*.

Vulnerability of the Securities Industry to Money Laundering

Regulators have focused on the vulnerability of the securities industry to money laundering activities subsequent to the events of September 11, 2001. In February 2003, Financial Action Task Force on Money Laundering (FATF), an independent international body comprising 29 member countries and governments, released its *2002–2003 Report on Money Laundering Typologies*. Chapter 2 is dedicated entirely to money laundering in the securities sector. According to this report, the securities industry possesses certain attributes that make it potentially vulnerable to being exploited by money launderers:

- The securities markets are not generally used for the placement stage of laundering. However, individual cases appear to show that the purchase of securities with illegally generated cash cannot be completely ruled out, even in jurisdictions that restrict or prohibit the acceptance of cash for such transactions.
- Because the industry relies on commissions for some of its operators, these professionals—whether individual brokers or employees of brokerage firms—may be tempted to ignore rules or regulations in order to ensure that a particular operation or client does not go to the competition.
- In some securities markets, due diligence procedures on customers or the source of their funds are not always performed in a consistent manner or do not go beyond the last step of the transaction. Some professionals assume that due diligence has already taken place, thus they may not to be as vigilant.
- The highly international nature of the securities industry means that launderers can use operations involving multiple jurisdictions to further complicate and thus obscure the various components of a laundering scheme. Again, when multiple jurisdictions are involved, securities professionals may erroneously assume that adequate due diligence procedures on a particular customer have already taken place in another jurisdiction. The experts stressed the importance of international co-operation in obtaining records to combat money laundering and the underlying predicate offences.
- As with transactions conducted through other parts of the financial system, ownership and control can often be hidden through the use of nominees, legal entities, trusts, etc.

The report discusses in detail various methodologies used to launder money through financial institutions, including the securities industry, and provides case studies. Securities firms may find useful information contained in this report when designing their anti-money laundering programs. You can find this report on the Web at http://www1.oecd.org/fatf/FATDocs_en.htm#Trends.

Forty Recommendations on Money Laundering

In June 2003, FATF revised its Forty Recommendations on Money Laundering. The revised Forty Recommendations apply not only to money laundering but also to terrorist financing. Among other things, the Recommendations address measures that should be taken by financial institutions to prevent money laundering and terrorist financing. This report can be accessed on the Web at http://www1.oecd.org/fatf/index.htm. The "Anti-Money Laundering Developments" section of this Alert discusses a number of anti-money laundering rules that were issued by the Department of the Treasury along with the SEC, the Commodity Futures Trading Commission (CFTC), and other regulatory agencies over the past two years.

The Commodities Industry

Global futures and options contract volume in the first nine months of 2003 set a new record, surpassing by 30 percent the volume traded over the same period of 2002.

At U.S. derivatives exchanges, increased trading of equity index and interest rate futures led the way during the first nine months of 2003. Total domestic futures contract volume reached 779 million contracts, up by 154 million contracts, or 25 percent, over the comparable 2002 period. Combined with options on futures and options on securities, total volume at U.S. derivatives exchanges reached 1.6 billion contracts in the first nine months of 2003, up16 percent over the same period a year ago.

Outside the United States, growth was stronger and dispersed more widely. Record increases in the trading of index options, index futures, and short-term interest rate contracts helped drive total international volume to more than a threefold increase over the same period a year ago.

Regulatory Issues and Developments[1]

Chapter 5, "Auditing Considerations," of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* discusses auditing considerations for an audit of the financial statements of a broker-dealer. The Guide notes that the regulatory environment of a broker-dealer has a major effect on the audit of a broker-dealer because of the requirements that auditors report on the adequacy of the broker-dealer's internal control and on its compliance with the specific rules addressing financial responsibility and recordkeeping. Accordingly, certain tests of controls are performed even if the auditor would not otherwise choose to do so.

The audit and reporting requirements for securities broker-dealers are regulated by Rule 17a-5 under the Securities Exchange Act of 1934. An alternative regulatory framework has been created for over-the-counter derivatives dealers that establishes a special class of broker-dealers who may choose to register with the SEC under a limited regulatory structure. Registered broker-dealers in U.S. government securities are regulated by Section 405.02 of the regulations pursuant to Section 15C of the Exchange Act.

Qualifications and reports of independent accountants of commodity entities are specified by Regulation 1.16 of the Commodity Exchange Act. Before undertaking the audit of a regulated entity, auditors should read the applicable rules and understand the prescribed scope of the audit and the related reporting requirements.

1. Readers should be alert for updates, amendments, or other changes to the rules discussed in this section and for other recent developments related to regulatory activities. The brief summaries provided in this section of the Alert are for informational purposes only. Readers should refer to the full text of the regulations. The complete text of Securities and Exchange Commission (SEC) final rules, including rules adopted subsequent to the publication of this Alert, can be obtained from the SEC Web site at www.sec.gov. The complete text of Commodity Futures Trading Commission (CFTC) final rules, including rules adopted subsequent to the publication of this Alert, can be obtained from the CFTC Web site at www.cftc.gov. See the "Information Sources" table at the end of this Alert for a list of Internet resources, including some Web sites that can provide additional information on regulatory issues and developments.

Certain regulatory activities and developments relevant to entities operating in the securities industry are presented below. In addition, certain regulatory developments are discussed in other sections of this Alert.

SEC Regulations

In addition to reading about the regulatory matters presented below, see the AICPA general *Audit Risk Alert—2003/04* and the AICPA *Independence and Ethics Alert—2003/04* for a discussion of some of the most important SEC regulations that have been issued recently that affect many industries, including the securities industry. Also, auditors should visit the SEC Web site at www.sec.gov to inform themselves about recent SEC rulemaking activities.

The following is a summary of some of the rules that the SEC issued since the writing of last year's Audit Risk Alert. For convenience, the rules were grouped into the following three categories: Rulemaking Related to Electronic Filing, Amendments to the Securities Exchange Act of 1934, and Other Rulemaking. Also refer to the AICPA general *Audit Risk Alert—2003/04* for a discussion of rulemaking related to the Sarbanes-Oxley Act.

Rulemaking Related to Electronic Filing

- *Mandated Electronic Filing and Website Posting for Forms 3, 4 and 5.* In May 2003, the SEC adopted rule and form amendments to mandate the electronic filing, and Web site posting by issuers with corporate Web sites, of beneficial ownership reports filed by officers, directors, and principal security holders under Section 16(a) of the Securities Exchange Act of 1934, generally as required by Section 403 of the Sarbanes-Oxley Act of 2002. Effective date: June 30, 2003. See Release No. 33-8230 for compliance date and other information.
- *Acceleration of Periodic Report Filing Dates and Disclosure Concerning Website Access to Reports.* In April 2003, the SEC provided corrections to final rules related to the acceleration of the filing of quarterly and annual reports

under the Securities Exchange Act of 1934 by certain accelerated filers which were published in the Federal Register on Monday, September 16, 2002 (67 FR 58480). Effective date: April 14, 2003. See Release No. 33-8128A for more information.

Amendments to the Securities Exchange Act of 1934

- *Broker-Dealer Exemption from Sending Certain Financial Information to Customers*. In August 2003, the SEC adopted amendments to a rule under the Securities Exchange Act of 1934 that provide a conditional exemption from the rule's requirement that a broker-dealer that carries customer accounts send its full balance sheet and certain other financial information to each of its customers twice a year. Under the amendments, the broker-dealer can send its customers summary information regarding its net capital, as long as it also provides customers with a toll-free number to call for a free copy of its full balance sheet, makes its full balance sheet available to customers over the Internet, and meets other specified requirements. The amendments are intended to reduce the cost of doing business for a broker-dealer while providing customers of the broker-dealer with easy access to the information they need to evaluate the financial soundness of the broker-dealer. Effective date: September 5, 2003. See Release No. 34-48272 for more information.
- *Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934*. In March 2003, the SEC issued corrections to the amendments to the books and records requirements for brokers and dealers under the Securities Exchange Act of 1934 that were published on November 2, 2001 (66 FR 55817). The corrections redesignate two paragraphs that were incorrectly numbered and amend references to those two paragraphs to reflect that change. Effective date: May 2, 2003. See Release No. 34-44992A for more information.

- *Customer Protection—Reserves and Custody of Securities: Delegation of Authority to the Director of the Division of Market Regulation*. In March 2003, the SEC adopted an amendment to its broker-dealer customer protection rule under the Securities Exchange Act of 1934. Currently, broker-dealers are required to provide cash, U.S. Treasury bills or notes, or irrevocable bank letters of credit as collateral when borrowing securities from customers. The amendment allows the SEC to expand the categories of permissible collateral by order. In addition, the SEC adopted a rule amendment delegating authority to the director of the Division of Market Regulation to issue such orders. Effective date: April 16, 2003. See Release No. 34-47480 for more information.
- *Definition of Terms in and Specific Exemptions for Banks, Savings Associations, and Savings Banks Under Sections 3(a)(4) and 3(a)(5) of the Securities Exchange Act of 1934.* In February, the SEC adopted amendments to its rule granting an exemption to banks from dealer registration for a *de minimis* number of riskless principal transactions, and to its rule that defines terms used in the bank exception to dealer registration for asset-backed transactions. The SEC also adopted a new exemption for banks from the definition of broker and dealer under the Securities Exchange Act of 1934 for certain securities lending transactions. In addition, the SEC extended the exemption from rescission liability under Section 29 of the Securities Exchange Act to contracts entered into by banks acting in a dealer capacity before March 31, 2005. These rules address certain of the exceptions for banks from the definitions of "broker" and "dealer" that were added to the Securities Exchange Act of 1934 by the Gramm-Leach-Bliley Act. See Release No. 34-47364 for more information. Also see Releases No. 34-47366 and No. 34-47649 for orders extending temporary exemption of banks, savings associations, and savings banks from the definitions of "broker" and "dealer" under the Exchange Act.

- *Exemption for Standardized Options From Provisions of the Securities Act of 1933 and From the Registration Requirements of the Securities Exchange Act of 1934*. In December 2002, the SEC adopted new exemptions under the Securities Act of 1933 and the Securities Exchange Act of 1934 for most standardized options. The new rules exempt standardized options issued by registered clearing agencies and traded on a registered national securities exchange or a registered national securities association from all provisions of the Securities Act, other than the Section 17 antifraud provision, as well as the Securities Exchange Act registration requirements. The rules also clarify that a security futures product that is cleared by a registered clearing agency or that is exempt from registration and traded on a registered national securities exchange or a registered national securities association is exempt from the registration requirements of Section 12(g) of the Securities Exchange Act. The rules ensure comparable regulatory treatment of standardized options and security futures products. Effective date: January 2, 2003. See Release No. 33-8171 for more information.

- *Repeal of the Trade-Through Disclosure Rules for Options.* In December 2002, the SEC repealed its options trade-through disclosure rule under the Securities Exchange Act of 1934, which requires a broker-dealer to disclose to a customer when the customer's order for listed options has been executed at a price inferior to a better published quote, unless the order was executed as part of a block trade or the transaction was effected on a market that participates in an intermarket options linkage plan featuring adequate trade-through protections. The SEC determined that amendments to the Options Intermarket Linkage Plan satisfied the regulatory goals that the options trade-through disclosure rule was designed to address, and is therefore repealing the rule as unnecessary. Effective date: December 27, 2002. See Release No. 34-47013 for more information.

Other Rulemaking

- *Customer Identification Programs For Broker-Dealers.* The Department of the Treasury, through the Financial Crimes Enforcement Network (FinCEN), and the SEC jointly adopted a final rule that requires broker-dealers to implement written Customer Identification Programs. This rule became effective June 9, 2003. Broker-dealers subject to this final rule must comply with it by October 1, 2003. See Release No. 34-47752 for more information on this rule. See the "Anti-Money Laundering Developments" section of this Alert for a discussion of this and other recent anti-money laundering rules.
- *Regulation Analyst Certification*. In February 2003, the SEC adopted new Regulation Analyst Certification. See the "Research Analyst Conflicts of Interest" section of this Alert for a brief summary of this rule. Effective date: April 14, 2003. See Release No. 33-8193 for more information.

Other Recent SEC Developments

The following is a brief discussion of some other SEC developments that might be of interest to broker-dealers and their auditors.

SEC Interpretive Releases[2]

Books and Records Requirements for Brokers and Dealers Under the Securities Exchange Act of 1934. Rule 17a-3 and Rule 17a-4 under the Securities Exchange Act (the Books and Records Rules) specify minimum requirements with respect to the records that broker-dealers must make, and how long those records and other documents relating to a broker-dealer's business must be kept. The SEC amended its Books and Records Rules on October 26, 2001 to clarify and expand recordkeeping requirements with respect to purchase and sale documents, customer records,

2. The SEC from time to time will provide guidance relating to topics of general interest to the business and investment communities by issuing an "interpretive release," in which it publishes its views on the subject matter and interprets the federal securities laws and its own regulations. The SEC Interpretive Releases are available on the SEC Web site at www.sec.gov.

associated person records, customer complaints, and certain other matters. The amendments expanded the types of records that broker-dealers must maintain and required broker-dealers to maintain or promptly produce certain records at each office to which those records relate. In May 2003, the SEC published guidance to clarify certain issues relating to broker-dealer books and records rules. Some of these issues have been raised as a result of the amendments to these rules that were adopted on October 26, 2001. Effective date of interpretation: May 29, 2003. See Release No. 34-47910 for more information.

Electronic Storage of Broker-Dealer Records. The SEC is publishing its views on the operation of its rule permitting broker-dealers to store required records in electronic form. Under the rule, electronic records must be preserved exclusively in a non-rewriteable and non-erasable format. This interpretation clarifies that broker-dealers may employ a storage system that prevents alteration or erasure of records for their required retention period. Effective date of interpretation: May 12, 2003. See Release No. 34-47806 for more information.

Other SEC Orders, Notices, and Information

Broker-Dealer Financial Statement Requirements under Section 17 of the Exchange Act. Section 17(e)(1)(A) of the Securities Exchange Act of 1934 (Exchange Act) requires that every registered broker-dealer annually file with the SEC a certified balance sheet and income statement, and Section 17(e)(1)(B) requires that the broker-dealer annually send to its customers its "certified balance sheet." The Sarbanes-Oxley Act of 2002 (SOA) established the Public Company Accounting Oversight Board (PCAOB) and amended Section 17(e) to replace the words "an independent public accountant" with "a registered public accounting firm." The SOA establishes a deadline for registration with the PCAOB of auditors of financial statements of "issuers," as that term is defined in the SOA. The SOA does not provide a deadline for registration of auditors of broker-dealers that are not issuers ("non-public broker-dealers"). Application of registration requirements and procedures to auditors of non-public broker-dealers is still being considered. Accordingly, the SEC believes that it is consistent with the public interest and the protection of investors that non-public broker-dealers file with the SEC and send to their customers the documents and information required by Section 17(e) certified by an independent public accountant instead of a registered public accounting firm until January 1, 2005, unless rules are in place regarding PCAOB registration of auditors of non-public broker-dealers that set an earlier date. See Release No. 34-48281 issued on August 4, 2003 for more information.

Exemption for Transactions in Certain Exchange-Traded Funds from the Trade-Through Provisions of the Intermarket Trading System. In May 2003, the SEC extended through March 4, 2004, a *de minimis* exemption for transactions in certain exchange-traded funds from the trade-through provisions of the Intermarket Trading System. The SEC emphasized that the *de minimis* exemption does not relieve brokers and dealers of their best execution obligations under federal securities laws and SRO rules. See Release No. 34-47950 for more information.

Order Regarding the Collateral Broker-Dealer Must Pledge When Borrowing Customer Securities. In April 2003, the SEC issued an order by which it allowed broker-dealers that borrow fully-paid and excess margin securities from customers to pledge a wider range of collateral than was permitted under paragraph (b)(3) of Rule 15c3-3 (17 CFR 240.15c3-3). See Release No. 34- 47683 for more information.

Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks from the Definition of "Broker" under Section 3(a)(4) of the Securities Exchange Act of 1934; Notice of Intent to Amend Rules. In April 2003, the SEC extended the temporary exemption of banks, savings associations, and savings banks from the definition of "broker" under the Securities Exchange Act of 1934 until November 12, 2004. The SEC expects to amend interim final rules that it issued on May 11, 2001, and further extend the temporary exemption from the definition of "broker," as appropriate, so that banks will have a sufficient transition period to bring their operations into compliance with the new statutory scheme based on the guidance (and exemptions) provided in the amended rules. See Release No. 34-47649 for more information.

Order Extending Temporary Exemption of Banks, Savings Associations, and Savings Banks from the Definition of "Dealer" under Section 3(a)(5) of the Securities Exchange Act of 1934. In February 2003, the SEC extended until September 30, 2003 its temporary order issued under Section 36 of the Exchange Act exempting banks, savings associations, and savings banks from the definition of the term "dealer" in Exchange Act Section 3(a)(5). See Release No. 34-47366 for more information.

Order Exempting Options Specialists from Section 11(b) of the Securities Exchange Act of 1934 When Accepting Certain Types of Complex Orders. In February 2003, the SEC exempted options specialists, subject to certain conditions, from the provisions of Section 11(b) of the Securities Exchange Act of 1934 to allow them to accept orders in option contracts on the same underlying security where the customer specifies the number of contracts for each series and the net debit or credit at which the order will be executed (complex orders), including spread, straddle, and combination orders. The SEC set forth certain conditions that should help to ensure that a specialist is not able to unduly influence market trends through his or her handling of complex orders. These conditions should help provide the type of protection that the prohibition in Exchange Act Section 11(b) was enacted to provide, and at the same time permit exchange specialists (not solely floor brokers, of which there are relatively few) to accept complex orders. See Release No. 34-47319 for more information.

SEC Special Studies

Implications of the Growth of Hedge Funds. On September 29, 2003, the SEC released a report on hedge funds following a comprehensive study of their operations and service providers (including broker-dealers) and the interaction of hedge funds with investors and the markets generally. The report outlines the SEC staff's factual findings from the study, identifies concerns, and recommends certain regulatory and other modifications to improve the current system of hedge fund regulation and oversight.

Among other things, the SEC staff recommended that the SEC and the NASD monitor closely capital introduction services provided by broker-dealers and watch closely for violations of broker-dealer suitability obligations with respect to the sale of funds of hedge funds (FOHFs). Readers should also be aware that in February 2003, the NASD issued Notice to Members 03-07, *NASD Reminds Members of Obligations When Selling Hedge Funds*, following its review of broker-dealers that sell hedge funds and registered products (closed-end funds) that invest in hedge funds.

Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System. On August 7, 2003, the SEC together with the Federal Reserve Board and the Office of the Comptroller of the Currency published an *Interagency Paper on Sound Practices to Strengthen the Resilience of the U.S. Financial System.* The paper identifies three new business continuity objectives that have special importance in the post-September 11 risk environment for all financial firms. The paper also identifies four sound practices to ensure the resilience of the U.S. financial system, which focus on minimizing the immediate systemic effects of a wide-scale disruption on critical financial markets. The paper applies most directly to the clearing and settlement activities of a limited number of financial institutions. The agencies expect organizations that fall within the scope of this paper to adopt the sound practices within the specified implementation timeframes, as described in more detail in the paper.

Joint SEC/NASD/NYSE Report of Examinations of Broker-Dealers Regarding Discounts on Front-End Sales Charges on Mutual Funds. The SEC, NASD and the NYSE conducted an examination sweep of 43 registered broker-dealers that sell mutual funds with a front-end sales load. The purpose of the examinations was to determine whether investors are receiving the benefit of available discounts on front-end sales charges in mutual fund transactions. Examinations were conducted between November 2002 and January 2003. In March 2003, the SEC, NASD and NYSE issued the report summarizing the results of these examinations, conclusions and remedial actions. See the discussion titled "Mutual Fund Breakpoints" in the "Economic and Industry Developments" section of this Alert for a brief summary of other developments in this area.

Enhancing Disclosure in the Mortgage-Backed Securities Markets. Staff of the Department of the Treasury, the Office of Federal Housing Enterprise Oversight, and the SEC formed a joint task force in August 2002 to conduct a study of disclosures in offerings of mortgage-backed securities (MBS). The purpose of the joint study was to evaluate current disclosure practices and consider whether disclosure enhancements are desirable in assisting investors to make informed investment decisions. In February 2003, the task force issued the report, which contains its findings, conclusions, and recommendations regarding enhanced MBS disclosures.

Study and Report on Violations by Securities Professionals. In January 2003, the SEC issued a report pursuant to Section 703 of the Sarbanes-Oxley Act of 2002 on the number of securities professionals who aided and abetted violators of, or were themselves primary violators of, federal securities laws between 1998 and 2001. Section 703(a)(1) of the Sarbanes-Oxley Act defines securities professionals as “public accountants, public accounting firms, investment bankers, investment advisers, brokers, dealers, attorneys, and other securities professionals practicing before the SEC.” This report reviews the scope and methodology of the study and summarizes the resultant data.

Report Pursuant to Section 704 of the Sarbanes-Oxley Act of 2002. Pursuant to Section 704 of the Sarbanes-Oxley Act, the SEC conducted a study of its enforcement actions over the past five years, which involved violations of reporting requirements imposed under the securities laws and restatements of financial statements, to identify areas of reporting that are most susceptible to fraud, inappropriate manipulation, or inappropriate earnings management. In January 2003, the SEC issued a report of its findings, including a discussion of recommended regulations or legislation.

Commodity Futures Trading Commission Regulations

The following is a summary of some of the rulemaking and orders issued by the CFTC in late 2002 and during 2003.

Proposed Amendments to Certain Minimum Financial and Related Reporting Requirements for Futures Commission

Merchants and Introducing Brokers. CFTC regulations currently require futures commission merchants (FCMs) to maintain minimum adjusted net capital in an amount equal to the greatest of: $250,000; 4 percent of customer funds required to be segregated by the Commodity Exchange Act and regulations; the amount of adjusted net capital required by a registered futures association of which it is a member; or, for those FCMs that also are registered as securities brokers or dealers with the SEC, the amount of net capital required by specified SEC regulations. On July 9, 2003, the CFTC published proposed amendments that would revise FCM capital computations and affect the application of certain capital charges for FCMs. See 68 *Federal Register* 40835 (July 9, 2003). Specifically, the proposed amendments, if adopted, would:

- Amend Rule 1.17(a) to delete that part of the minimum adjusted net capital requirement that is based on segregated customer funds and replace it with an amount based on maintenance margin levels of futures and options positions carried by an FCM. The proposed amendment would reflect risk-based capital rules that have already been adopted by a clearing organization, two exchanges, and the National Futures Association (NFA).
- Amend Rule 1.12(b), Rule 1.17(e), and Rule 1.17(h) to provide margin-based capital computations for purposes of "early warning," equity capital, and satisfactory subordination agreements.
- Amend Rule 1.17(c) to reduce the periods allowed before an FCM must take a capital charge for outstanding margin calls.

In addition to rules relating to an FCM's capital requirements, the CFTC also proposed amendments to reporting requirements applicable to FCMs and introducing brokers (IBs). In particular, the CFTC proposed to reduce the time periods set forth in Rule 1.12(c) (requirements for failure to maintain current books and records) and Rule 1.12(d) (requirements upon discovery of a material inadequacy in a firm's accounting systems). The CFTC proposed to amend these paragraphs to require the FCM or IB to take specified actions within the same time frames currently provided in SEC rules applicable to securities brokers and dealers. The CFTC further proposed to amend filing requirements for FCMs or IBs to streamline commission procedures and eliminate unnecessary filing requirements.

The comment period for the proposed amendments closed on September 8, 2003. The CFTC had not issued final rules as of the publication of this Alert.

Denomination of Customer Funds and Location of Depositories. The CFTC adopted Rule 1.49, which permits FCMs and derivatives clearing organizations (DCOs), under certain conditions, to deposit customer funds in foreign depositories and in certain currencies other than U.S. dollars. The CFTC also adopted amendments to Appendix B of its Part 190 bankruptcy rules, which governs the distribution of property where a bankrupt FCM or DCO maintains customer property in depositories outside the United States or in a foreign currency. This new distributional framework is intended to ensure that customers whose funds are held in a U.S. depository will not be adversely affected by a shortfall in the pool of funds held in a depository outside the United States caused by the sovereign action of a foreign government or court. The rule replaces the CFTC's Financial and Segregation Interpretation No. 12 and became effective March 6, 2003. (As of the publication of this Alert, the CFTC had also proposed additional rules regarding FCM investment of customer funds. See 68 FR 3864, June 30, 2003, and 68 FR 46516, August 6, 2003, for details.)

Review of Commodity Pool Annual Reports Assigned to the National Futures Association. By order dated December 18, 2002, the CFTC authorized NFA to review commodity pool annual financial reports (the order may be found at http://www.cftc.gov/foia/fedreg02/foi021218c.htm). Accordingly, for fiscal years ending on or after December 31, 2002, commodity pool operators (CPOs) need to file only one copy of each pool annual report with the NFA. CPOs are no longer required to file copies of any such annual reports with the CFTC. However, annual reports must continue to comply with appropriate CFTC rules.

In addition, requests for time extensions to distribute annual financial reports under Rule 4.22(f)(1), claims for extensions under Rule 4.22(f)(2), and notices of eligibility for exemption from registration and from certain provisions of Part 4 of the commission's regulations required to be filed by CPOs and commodity trading advisors (CTAs) also should be filed only with the NFA. Any commodity pool-related documents received by the CFTC will be forwarded to the NFA.

Commodity Trading Advisor Performance Disclosures. The CFTC adopted regulations establishing a core principle for CTAs with regard to performance disclosures concerning partially funded accounts. The core principle specifies that such disclosure must be offered in a manner that is balanced and is not in violation of the antifraud provisions of the Commodity Exchange Act or CFTC regulations. The regulations became effective August 20, 2003, and are available at http://www.cftc.gov/foia/fedreg03/foi030721a.htm. The CFTC also addressed certain issues related to calculation and presentation of past performance by CPOs and CTAs, including disclosure of the range of rates of return for closed accounts or other measures of variability in returns experienced by clients for the offered trading program, computation of program draw-down information on a composite basis, and methods to account for the effect of intramonth additions and withdrawals in the computation of rate of return. These changes became effective September 8, 2003, and are available at http://www.cftc.gov/foia/fedreg03/foi030808a.htm.

Registration and Other Regulatory Relief for Commodity Pool Operators and Commodity Trading Advisors. The CFTC has modernized a number of key rules regarding CPOs and CTAs to rationalize requirements, remove unnecessary regulatory burdens, and facilitate greater participation in the commodity futures and options markets, which can benefit all market participants by increasing liquidity. The changes include:

- Providing that institutions excluded from the definition of CPO under Rule 4.5 will no longer be restricted in the amount of futures transactions they can enter into to qualify for the exclusion.

- Providing additional exemptions from the CPO and CTA registration requirements for those entities that have limited futures activity or that restrict participation to sophisticated persons.
- Facilitating communications by CPOs and CTAs with prospective and existing pool participants and clients, including permitting certain information to be provided in advance of the distribution of a disclosure document.
- Eliminating duplicative regulatory requirements for "master/feeder fund" structures.

The CFTC also amended Rule 4.22 to permit CPOs to distribute periodic account statements and annual reports to pool participants by electronic means. The rule requires that, prior to transmission of any account statement or annual report to a pool participant by means of electronic media, a CPO must disclose to the participant that it intends to distribute these documents electronically, absent objection from the participant no later than 10 business days following its receipt of the disclosure. These regulations became effective August 8, 2003, and are available at http://www.cftc.gov/foia/fedreg03/foi030808a.htm.

Bunched Orders. The CFTC amended Rule 1.35(a-1)(5) to allow certain account managers to bunch customer orders for execution and allocate the orders to individual accounts at the end of the day. The amended rule expands the availability of bunching to all customers, simplifies the process, and clarifies the respective responsibilities of account managers and FCMs with respect to establishing a methodology for bunching and allocating orders. The amendments became effective July 11, 2003.

Patriot Act Implementation. The Department of the Treasury, through the Financial Crimes Enforcement Network, and the CFTC jointly adopted a final rule that requires FCMs and IBs to implement written customer identification programs. This rule became effective June 9, 2003. FCMs and IBs subject to this final rule must comply by October 1, 2003. See the "Anti-Money Laundering Developments" section of this Alert for more information on this and other anti-money laundering rules.

> **Help Desk**—The complete text of the preceding rules, along with other CFTC final rules, including rules adopted and changes made subsequent to the publication of this Audit Risk Alert, can be downloaded from the CFTC's Web site at www.cftc.gov.

Commodity Futures Trading Commission Annual "Dear CPO" Letter

On March 6, 2003, CFTC staff sent a letter to all CPOs that outlined key reporting issues and common reporting deficiencies found in annual financial reports for commodity pools. The letter pointed out the CFTC staff's concerns and, accordingly, may alert the auditor to high-risk issues that could affect assertions contained in the financial statements of commodity pools. CFTC staff suggested that CPOs share the letter with their independent auditors.

Addressed in the letter as major concerns were:

- Applicability of GAAP to commodity pools' annual financial statements
- Audit opinion
- Master/feeder structures
- Extended due date for fund-of-fund pools
- New pools—initial annual financial reports
- Final annual financial reports
- Simplification for filing annual financial reports, time extensions, and certain exemptions—Delegation Order to NFA
- Additional relief from registration as a CPO—advance notice of proposed rulemaking
- Anti-money laundering and terrorist financing

To avoid some of the most common and easily remedied deficiencies, the letter suggested that CPOs do the following:

- File one copy of the report with the NFA. CPOs are no longer required to file copies of any such reports with the CFTC.
- File the report as soon as possible, but no later than the due date. For pools with a December 31, 2003, year end, the due date is Tuesday, March 30, 2004 (unless a time extension has been granted). CPOs operating a fund-of-funds pool should review the streamlined procedures described in CFTC Regulation 4.22(f)(2) for requesting an extended due date.
- Include a signed oath or affirmation, as required by CFTC Regulation 4.22(h), with each and every copy of the report, filed with NFA. Binding the oath as part of the report package or attaching it to the cover page is a helpful practice followed by a number of CPOs.
- If the pool is operating under the exemptions granted under Rule 4.7 or 4.12, those regulations require that a notation of that fact be made on the cover page of the report.
- Report special allocations of partnership equity as required by CFTC Interpretive Letter 94-3, *Special Allocations of Investment Partnership Equity*. (The letter is available at the CFTC Web site at www.cftc.gov/tm/tm94-03.htm.)
- Net Asset Value:
    - For unitized pools, include information concerning net asset value per outstanding participation unit in the pool as of the end of each of the pool's two preceding years.
    - For non-unitized pools, provide to each participant the total value of that participant's interest or share in the pool as of the end of each of the pool's two preceding fiscal years. Also provide a schedule listing each participant's balances for those years. A code for each participant may be used in lieu of the participant's name, as participants should not receive financial information concerning other participants.

- If the annual financial report is unaudited (pursuant to the exemption of CFTC Rule 4.7):
  - Make a statement to that effect on the cover page of each report and state that a certified audit will be provided on request of a majority of the units of participation in the pool that are unaffiliated with the CPO.
  - Present and compute the annual report in accordance with GAAP consistently applied. This includes the requirements of AICPA Statement of Position (SOP) 95-2, *Financial Reporting by Nonpublic Investment Partnerships*, as amended by SOP 01-1, *Amendment to Scope of Statement of Position 95-2*, Financial Reporting by Nonpublic Investment Partnerships, *to Include Commodity Pools*, and CFTC Interpretative Letter 94-3.
  - Include in the annual report appropriate footnote disclosures, including information concerning net asset values or schedules of participants' interests, as required by CFTC Regulation 4.22(c)(2).

Previously issued letters to commodity pool operators are available at the CFTC Web site, www.cftc.gov, under the heading "Law & Regulation, Compliance."

Self-Regulatory Organization Regulations

NYSE/NASD/AMEX Rulemaking

Under the Securities Exchange Act of 1934, all broker-dealers are required to be members of self-regulatory organizations such as the NYSE, NASD, or other organization that is designated to perform routine surveillance and monitoring of its members. During the past year, a number of significant regulations were issued by SROs, including the following:

- *Research Analyst Conflicts of Interest.* In July 2003, the SEC approved proposed rule changes by the NYSE, as amended by Amendments No. 1, 2, and 3 relating to its Rules 344 ("Supervisory Analysts"), 345A ("Continuing Education for Registered Persons"), 351 ("Reporting Requirements"), and 472 ("Communications with the Public"), and by the NASD, as amended by Amendments No. 1, 2, and 3 relating to research analyst conflicts of interest, Conduct Rule 2711. See the "Research Analyst Conflicts of Interest" section of this Alert for a brief summary of these rule changes. See Release No. 34-48252 for more information.

- *Equity Compensation Plans.* In June 2003, the SEC approved NYSE-proposed rule changes, as amended by Amendments No. 1 and 2, and rule changes proposed by the NASD through its subsidiary, the Nasdaq Stock Market, Inc. (Nasdaq), as amended by Amendments No. 1, 2, and 3, relating to equity compensation plans. As a result, the NYSE will adopt new Section 303A(8) of the NYSE's Listed Company Manual, which will require shareholder approval of all equity compensation plans and material revisions to such plans, subject to limited exemptions. The NYSE will also amend NYSE Rule 452 to prohibit member organizations from voting on equity compensation plans unless the beneficial owner of the shares has given voting instructions. In addition, the NYSE will make conforming changes to current Sections 303.00, 312.03, 312.04, and 402.08 of the NYSE's Listed Company Manual. Nasdaq will amend its Rule 4350(i) to require shareholder approval for stock option plans or other equity compensation arrangements (subject to exceptions specified in the rule), adopt "Interpretative Material" pertaining to shareholder approval for stock option plans or other equity compensation arrangements, and make related conforming changes to its Rules 4310(c)(17)(A) and 4320(e)(15)(A). See Release No. 34-48108 for more information. On October 14, 2003, the SEC approved on an accelerated basis a proposed rule change filed by the NASD through Nasdaq relating to its recently adopted rules regarding shareholder approval for stock option or purchase plans or other equity compensation arrangements. See Release No. 34-48627 for more information. On October 9, 2003, the SEC approved on an accelerated basis a proposal by the American Stock Exchange (AMEX) to amend Section 711 of the Amex Company Guide relating to shareholder approval of stock option and equity compensation plans. See Release No. 34-48610 for more information.

- *Requests for Withdrawal of Certificates by Issuers.* In June 2003, the SEC approved a proposed rule change by the Depository Trust Company (DTC) concerning requests for withdrawal of certificates by issuers. See Release No. 34-47978 for more information.
- *Order Tracking.* In April 2003, the SEC approved proposed rule changes by the NYSE relating to order tracking. As a result, the NYSE will adopt four new rules that will require members and member organizations to record and retain order information, to synchronize their time-keeping equipment with a time source designated by the NYSE, and to provide the NYSE with information on orders upon request. See Release No. 34-47689 for more information.
- *Dissemination of Liquidity Quotations.* In April 2003, the SEC approved proposed rule changes by the NYSE regarding the dissemination of liquidity quotations. As a result, the NYSE will amend its rules to permit the display and use of quotations in stocks traded on the NYSE to show additional depth in the market for those stocks. Because the SEC had substantial concern that the proposed rule change was not consistent with the requirements of the Securities Exchange Act of 1934 and the rules and regulations thereunder applicable to the NYSE, it approved the proposed rule change, as amended, conditional on the delayed effectiveness of the proposal. See Release No. 34-47614 for more information.

Other NASD/NYSE Information

Customer Notice Regarding Discontinuation of Excess SIPC Coverage. On July 14, 2003, the NYSE issued Information Memo No. 03-33, *Customer Notice Regarding Discontinuation of Excess SIPC Coverage.* On July 30, 2003, the NASD issued a member alert on the same subject. According to these documents, the Securities Investor Protection Act of 1970 created the Securities Investor Protection Corporation (SIPC) to provide customer protections against certain losses resulting from the failure of securities firms. SIPC's maximum protection limit per customer is $500,000, of which no more that $100,000 may be a claim for cash. Consequently, it is not uncommon for members or member organizations to provide, through an outside insurance company, excess SIPC coverage. Some insurance companies are discontinuing their supplemental SIPC insurance policies. Consequently, some members and member organizations that currently offer such protection may no longer do so in the near future. The availability of excess SIPC coverage may have served as an inducement or a determining factor for customers in deciding to open or maintain a securities account. Therefore, members and member organizations that offer additional or excess SIPC coverage should provide customers 30 days notice prior to the discontinuation or reduction of any such coverage.

NFA Rulemaking

New Rules Concerning Retail Off-Exchange (Forex) Foreign Currency Market. The CFTC approved several NFA rules designed to protect investors in the retail off-exchange forex futures and option markets. The Commodity Futures Modernization Act of 2000 makes clear the commission's authority and jurisdiction to investigate and take action to close down entities selling off-exchange forex futures and option contracts to retail customers other than through a permitted counterparty, such as a firm registered as a futures commission merchant. The CFTC may also pursue action against a counterparty registered as an FCM based upon fraud or manipulation.

Since the passage of the Commodity Futures Modernization Act, a problem has remained with unregulated persons soliciting retail customers for forex transactions, even where a person registered as an FCM is a counterparty to the transaction with the retail customer. NFA's new rules address this problem by, among other things, making FCMs take responsibility for the activities of these unregulated persons, unless the intermediaries become NFA members, in which case NFA would have the ability to discipline the intermediaries for violation of NFA's antifraud and other rules.

In addition to making NFA's members registered as FCMs that act as counterparty in off-exchange forex transactions with retail customers take responsibility for the activities of these unregulated solicitors, the new rules, which became effective on December 1, 2003, impose several other requirements, including:

- Observing high standards of commercial honor and just and equitable principles of trade in connection with the retail forex business
- Supervising their employees and agents and any affiliates that act as counterparties to retail forex transactions
- Maintaining a minimum net capital requirement based on the value of open off-exchange forex customer positions
- Collecting security deposits from those customers.

The rules are available at the NFA Web site at www.nfa.futures.org.

Audit and Accounting Issues and Developments

Recording Certain Broker-Dealer Expenses and Liabilities

In July 2003, the SEC Division of Market Regulation sent a letter to the NASD and the NYSE (SROs) concerning the application of the financial responsibility rules[3] when a third party, which may include a parent, holding company, or affiliate of a broker-dealer, agrees to assume responsibility for payment of the broker-dealer's expenses. The SROs were concerned that some broker-dealers were using these expense-sharing agreements as a basis for not recording the costs they incurred on their books and records. In that instance, the books and records of a broker-dealer may not accurately reflect its performance and financial condition, artificially inflating its profitability, causing it to appear to be in capital compliance when it is not, and possibly disguising fraudulent activity.

3. Securities Exchange Act of 1934 Rules 15c3-1, 17a-3, 17a-4, and 17a-5.

Under the financial responsibility rules, broker-dealers are required to prepare certain financial statements in accordance with GAAP. A broker-dealer is also required to make and keep current certain books and records relating to its business, including records reflecting all assets and liabilities, income and expense and capital accounts. A broker-dealer must also retain copies of all written agreements entered into by the broker-dealer relating to its business.

The SEC Division of Market Regulation provided the following guidance:

1. Pursuant to Exchange Act Rule 17a-3(a)(1) and (a)(2), a broker-dealer must make a record reflecting each expense incurred relating to its business and any corresponding liability, regardless of whether the liability is joint or several with any person and regardless of whether a third party has agreed to assume the expense or liability. A broker-dealer must make a record of each expense incurred relating to its business, including the value of any goods or services used in its business, when a third party has furnished the goods or services or has paid or has agreed to pay the expense or liability, whether or not the recording of the expense is required by GAAP and whether or not any liability relating to the expense is considered a liability of the broker-dealer for net capital purposes. One proper method is to record the expense in an amount that is determined according to an allocation made by the third party on a reasonable basis.

2. If the broker-dealer does not record certain expenses on the reports it is required to file with the SEC or with its designated examining authority (DEA) under the financial responsibility rules, the broker-dealer may satisfy the Securities Exchange Act Rule 17a-3(a)(1) and (a)(2) requirement to make a record of those expenses by making a separate schedule of the expenses.

3. If a third party agrees or has agreed to assume responsibility for an expense relating to the business of the broker-dealer, and the expense is not recorded on the reports the broker-

dealer is required to file with the SEC or with its DEA under the financial responsibility rules, any corresponding liability will be considered a liability of the broker-dealer for net capital purposes unless:

- If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense.[4]
- The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense.
- There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense.
- The liability is not a liability of the broker-dealer under GAAP.
- The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expense.

4. Any withdrawal of equity capital, as defined in paragraph (e)(4)(ii) of Securities Exchange Act Rule 15c3-1, from a broker-dealer by a third party, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, within three months before or within one year after the broker-dealer incurs an expense which the third party has paid or agreed to pay, will be presumed for net capital purposes to have been made to repay the third party for the expense of the broker-dealer, unless the broker-dealer's books and records reflect a liability to the third party relating to the expense.

5. For purposes of determining net capital, if the broker-dealer records a capital contribution from a third party that has assumed responsibility for paying an expense of the broker-dealer, and the expense is not recorded on the

4. This requirement does not apply to a fixed-term arrangement with a lessor that was in place before the issuance of this guidance.

reports the broker-dealer is required to file with the SEC or with its DEA under the financial responsibility rules, the broker-dealer must be able to demonstrate that the recording of a contribution to capital is appropriate. Among other things, the broker-dealer must be able to demonstrate that the third party has paid the expense or has adequate resources independent of the broker-dealer to pay the expense and that the broker-dealer has no obligation, direct or indirect, to a vendor or other party to pay the expense. For net capital purposes, any equity capital withdrawn by the third party, other than a withdrawal described in paragraph (e)(4)(iii) of Securities Exchange Act Rule 15c3-1, within three months before or one year after the broker-dealer incurs the expense, will be deemed to have been a repayment of the expense to the third party. For net capital purposes, if a contribution to capital is made to a broker-dealer with an understanding that the contribution can be withdrawn at the option of the contributor, the contribution may not be included in the firm's net capital computation and must be re-characterized as a liability. Any withdrawal of capital as to that contributor within a period of one year, other than a withdrawal described in paragraph (e)(4)(iii) of Exchange Act Rule 15c3-1, shall be presumed to have been contemplated at the time of the contribution.

6. If a third party agrees or has agreed to assume responsibility for an expense of the broker-dealer, the broker-dealer must make, keep current, and preserve the following records pursuant to Exchange Act Rules 17a-3 and 17a-4:

    - If a vendor or other party has agreed that the broker-dealer is not liable directly or indirectly to the vendor or other party for an expense, a written agreement between the broker-dealer and the vendor or other party that clearly states that the broker-dealer has no liability, direct or indirect, to the vendor or other party
    - A record of each expense assumed by the third party

7. A broker-dealer must make, keep current, and preserve a written expense-sharing agreement[5] between the broker-dealer and a third party that has paid or agreed to pay an expense of the broker-dealer. The agreement must set out clearly which party is obligated to pay each expense, whether the broker-dealer has any obligation, direct or indirect, to reimburse or otherwise compensate any party for paying the expense, and, when the broker-dealer records the expense in an amount that is determined according to an allocation made by the third party, the method of allocation.
8. Each broker-dealer and broker-dealer applicant must be able to demonstrate to the appropriate authorities that it is in compliance with the financial responsibility rules in connection with any expense-sharing agreement it has entered into, and therefore may be required to provide these authorities with access to books and records, including those of unregistered entities, relating to the expenses covered by the agreement.
9. A broker-dealer must notify its DEA if it enters into, or has entered into, an expense-sharing agreement and the broker-dealer does not record each of the expenses it incurs relating to its business on the reports it is required to file with the SEC or with its DEA under the financial responsibility rules. The notification must include the date of the agreement and the names of the parties to the agreement. The broker-dealer must provide a copy of the agreement to its DEA upon request.

The SEC Division of Market Regulation letter can be found on the Web at http://www.sec.gov/divisions/marketreg/mr-noaction/macchiaroli071103.pdf. The NASD has provided further guidance on the issues addressed in the letter in Notice-to-Members 03-63 issued on October 29, 2003.

5. Expense-sharing agreements include franchising or other agreements relating to the costs of doing business of the broker-dealer.

Consideration of Fraud

As always, considering fraud remains a crucial responsibility for auditors of financial statements. Auditors should follow the requirements of SAS No. 99, *Consideration of Fraud in a Financial Statement Audit* (AICPA, *Professional Standards*, vol. 1, AU sec. 316). The 2003 edition of the AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012703kk) includes a new detailed discussion of SAS No. 99 that is tailored specifically for the securities industry.

In addition, the AICPA has issued guidance on the implementation of SAS No. 99, including *Fraud Detection in a GAAS Audit—SAS No. 99 Implementation Guide* (product no. 006613kk) and CPE courses titled *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk), *Auditing for Internal Fraud* (product no. 730237kk), and *Identifying Fraudulent Financial Transactions* (product no. 730244kk).

Auditing Considerations Related to Proprietary Trading

What Is Proprietary Trading?

A firm's trading account is usually a material item in a broker-dealer's statement of financial condition. Pricing of firm inventory may also have a material impact on the profit and loss. Given the increased popularity of proprietary trading this year and the potential risks involved, an auditor of a securities firm involved in proprietary trading needs to ensure that he or she properly plans and performs the audit in that area.

Firm trading activity can be broadly divided into dealer and positioning strategies. With a dealer strategy, the broker-dealer attempts to balance buy and sell transactions with different customers or other broker-dealers and earn the difference between the price paid on the purchase (bid) and the price received on the sale (ask). If a broker-dealer cannot simultaneously execute a buy and corresponding sell, the firm will be vulnerable to market volatility during the period between the execution of the purchase and the execution of the sale.

Positioning strategies involve the broker-dealer's buying and selling securities in anticipation of certain market movements and holding such positions for longer periods than with dealer strategies. Should a trader anticipate that a security's price will rise, the trader may take a long position in that security; if a security is expected to decline in value, the trader may take a short position. Positioning strategies are riskier than dealer strategies because the security is held for a longer time and significant losses can be incurred if a trader incorrectly forecasts the market. Also, short sale transactions may impact a broker-dealer's net capital. A broker-dealer with a proprietary short position in an equity security may be required to deduct a percentage of the market value of the position when computing net capital under Securities Exchange Act Rule 15c3-1.[6]

In addition to marketable securities, broker-dealers may purchase securities for investment that are not readily marketable or whose sale is restricted by the purchase terms. Securities purchased for investment should be designated and recorded separately in the accounts of a broker-dealer to meet the requirements of the Internal Revenue Service (IRS), since they are purchased with the expectation of future capital gains. The broker-dealer's records must clearly indicate by the close of the day on which an investment security is acquired that it is held for investment.

Security positions resulting from proprietary trading are reported at current market or fair values, and unrealized gains or losses resulting from marking these to the market or fair value are included in profit or loss. Proprietary securities transactions entered into by the broker-dealer for trading or investment purposes are included in "Securities Owned and Securities Sold, Not Yet Purchased."

Auditing Considerations

Auditors should refer to the guidance in SAS No. 92, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (AICPA, *Professional Standards*, vol. 1, AU sec. 322) and the companion AICPA Audit Guide, *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities*

6. See Rule 15c3-1(c)(2)(vi)(J) under the Securities Exchange Act of 1934.

(product no. 012520kk) when auditing transactions and accounts related to proprietary trading.

Valuation of Firm Inventory. To ensure that firm inventory is properly valued and reserves are properly established to adequately reflect exposure to market risk, the auditor should consider performing the following procedures:

- Test pricing procedures.
- Ascertain that bid prices are used for long positions and asked prices for short positions.
- Agree prices for selected securities to independent reliable sources with emphasis on positions with manual or override prices.[7]
- Develop alternative procedures to determine the reasonableness of management's valuation if no independent prices are available. For example, examine recent/subsequent trading activity; compare prices to similar securities based on maturity, rating, or other criteria; or revise assumptions used in models.
- Recalculate interest and dividend accruals for selected securities in inventory.
- Test inventory positions for concentrations in particular securities and ensure that the size of positions is taken into consideration, not only with respect to the firm's entire

7. Keep in mind that quoted market prices provide the most reliable measure of fair value. However, previously in certain situations, if a broker-dealer believed that the total market value of a financial instrument was not readily realizable (for example, if a broker-dealer made a market in a financial instrument or owned a substantial block of a financial instrument traded in an active market) it had been industry practice to apply block discounts to such positions. In November 2003, FASB affirmed its March 2003 decision for financial instruments traded in active markets to retain the principle in FASB Statement No. 107, *Disclosures about Fair Value of Financial Instruments*, that establishes that the unit of account is the individual trading unit and prohibits a fair value measurement using a block discount. For assets and liabilities that are not traded in active markets, FASB decided not to reconsider the unit-of-account guidance in other existing pronouncements as part of its fair value measurement project.

inventory, but also in relation to what the market can absorb (blockage). [8]

- Test aging of inventory.
- Understand risk management procedures for monitoring overall exposure, including the use of hedges to reduce exposure to market risk.
- Determine that reserves are sufficient relative to exposure.

Principal Transaction Revenue. To ensure that revenue from proprietary trades is fairly stated and recorded in the proper period, the auditor should consider performing the following procedures:

- Perform detail tests of realized revenue recognized on selected principal transactions:
  - Agree selected transactions to general ledger and stock record activity.
  - Determine the opening market value (cost basis) and the transaction price to recalculate the gain or loss on the selected transactions.
  - Agree the unrealized gain or loss to the daily summary.
- Perform detail tests of unrealized gains and losses by verifying closing prices to independent price sources and recalculating daily profit and loss (P&L) for selected principal transactions.
- Perform analytical procedures and analyze unusual variances:
  - Quarter-to-quarter
  - Year-to-year
- Beginning with source documentation, recalculate the principal transactions revenue on a sample basis and agree the amounts to the general ledger.

Firms that transact in less liquid instruments are challenged by the requirements of Emerging Issues Task Force (EITF) Issue No. 02-3, *Issues Involved in Accounting for Derivative Contracts Held for Trading*

8. See footnote 7.

Purposes and Contracts Involved in Energy Trading and Risk Management Activities, which precludes them from recognizing dealer profit, or unrealized gain or loss at the inception of the contract, absent observable market prices or inputs.

When testing firm trading, the auditor also needs to make sure that the broker-dealer accrues for inventory positions relating to unsettled trades.

Consideration of Internal Control. When determining the nature, timing, and extent of substantive tests to be performed with respect to firm trading, the auditor needs to consider the internal controls and the assessed level of control risk in that area. Given the volatility of the financial markets, proper control and monitoring activities over firm trading activities are especially critical. Some of the control and monitoring activities that are typically associated with firm trading include:

- Establishing overall position limits, as well as separate limits for each trader and product.
- Daily monitoring of positions and trading gains and losses by each trader on a trade date basis.
- Daily reconciling trading desk records, which are maintained on a trade date basis, to the accounting department records.
- Daily marking to market firm trading positions with prices obtained from independent pricing sources.
- Reviewing all trader-determined valuations or overridden valuations.
- Management review of reports of all aged positions.
- Management review of reports of position concentrations.
- Sending trade confirmations to each counterparty.
- Recording traders' phone conversations with counterparties.
- Reviewing daily the automated comparison of settled positions on the firm inventory system versus positions on the stock record.

- Comparing trade tickets to the daily transaction information recorded on the firm's books and records.
- Time-stamping trade tickets at the time a transaction is received and executed.
- Reviewing and verifying all confirmations received from counterparties.
- Daily balancing principal transactions conducted with the broker-dealer's customers.

Litigation, Claims, and Assessments

As discussed in the "Economic and Industry Developments" section of this Alert, securities firms are facing numerous investigations by regulators that are likely to result in significant payouts. Also, the number of arbitration claims filed by investors against brokers is expected to reach an all-time high this year. NASD Dispute Resolution reported that case filings through September 2003 was up 22 percent compared to the same period in 2002. Lawyers say that more claims for over a million dollars are being filed and the awards to investors are getting higher. Some investors are collecting the full amount of the alleged compensatory damages. As an auditor of a securities firm involved in legal proceedings, you may need to evaluate management's consideration of the financial accounting and reporting implications of those proceedings pursuant to FASB Statement No. 5, *Accounting for Contingencies*. FASB Statement No. 5 addresses accounting and reporting for loss contingencies, including those arising from litigation, claims, and assessments.

In addition, auditors need to be aware of their responsibilities under SAS No. 12, *Inquiry of a Client's Lawyer Concerning Litigation, Claims, and Assessments* (AICPA, *Professional Standards*, vol. 1, AU sec. 337). SAS No. 12 provides guidance on the procedures an independent auditor should consider for identifying litigation, claims, and assessments and for the financial accounting and reporting of such matters when performing an audit in accordance with generally accepted auditing standards (GAAS).

It provides, in part, that auditors should obtain evidential matter relevant to the following factors:

- The existence of a condition, situation, or set of circumstances indicating an uncertainty as to the possible loss to an entity arising from litigation, claims, and assessments
- The period in which the underlying cause for legal action occurred
- The degree of probability of an unfavorable outcome
- The amount or range of potential loss

Because the events or conditions that should be considered in the financial accounting for and reporting of litigation, claims, and assessments are matters within the direct knowledge and, often, control of the management of an entity, management is the primary source of information about such matters. Accordingly, the independent auditor's procedures with respect to litigation, claims, and assessments should include the following:

- Inquire of and discuss with management the policies and procedures adopted for identifying, evaluating, and accounting for litigation, claims, and assessments.
- Obtain from management a description and evaluation of litigation, claims, and assessments that existed at the date of the balance sheet being reported on, and during the period from the balance sheet date to the date the information is furnished, including an identification of those matters referred to legal counsel; and obtain assurances from management, ordinarily in writing, that it has disclosed all such matters required to be disclosed by FASB Statement No. 5.
- Examine documents in the client's possession concerning litigation, claims, and assessments, including correspondence and invoices from lawyers.
- Obtain assurance from management, ordinarily in writing, that it has disclosed all unasserted claims that the lawyer has advised them are probable of assertion and must be disclosed in accordance with FASB Statement No. 5.

> In addition, the auditor, with the client's permission, should inform the lawyer that the client has given the auditor this assurance. This client representation may be communicated by the client in the inquiry letter or by the auditor in a separate letter.

An auditor ordinarily does not possess legal skills, and therefore cannot make legal judgments concerning information coming to his or her attention. Accordingly, the auditor should request that the client's management send a letter of inquiry to those lawyers with whom management consulted concerning litigation, claims, and assessments.

Auditors also need to be aware that contingent liabilities could result in an increase in a broker-dealer's aggregate indebtedness and, accordingly, its net capital requirement. According to a comment from the SEC to NASD, a broker-dealer that is the subject of a lawsuit that could have a material impact on its net capital must obtain an opinion of counsel regarding the potential effect of such a suit on the firm's financial condition. Absent such opinion, the item must be considered, at a minimum, a contingent liability and included in the calculation of aggregate indebtedness.

The audit normally includes certain other procedures undertaken for different purposes that might also disclose litigation, claims, and assessments. Such procedures might include reading minutes of meetings of stockholders, directors, and appropriate committees; reading contracts, loan agreements, leases, correspondence from taxing or other governmental agencies, and similar documents; obtaining information concerning guarantees from bank confirmation forms; and inspecting other documents for possible guarantees by the client.

Anti-Money Laundering Developments

Over the past two years, the Department of the Treasury, along with other regulatory organizations, has issued a number of rules to implement key provisions of the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism (USA Patriot) Act of 2001. In 2003, many of these rules became effective and began to be enforced. It is critical for securities firms to comply with anti-money laundering regulations, as noncompliance may lead to serious negative consequences, including tarnished reputation, legal and regulatory problems, and, in some cases, civil or criminal actions.

Money launderers tend to use the business entity more as a conduit than as a means of directly expropriating assets. For this reason, money laundering is far less likely to affect financial statements than are other types of fraud, such as misappropriation, and consequently is unlikely to be detected in a financial statement audit. In addition, other forms of fraudulent activity usually result in the loss or disappearance of assets or revenue, whereas money laundering involves the manipulation of large quantities of illicit proceeds to distance them from their source quickly and in as undetectable a manner as possible. However, money laundering activities may have indirect effects on an entity's financial statements.

Money laundering is considered to be an illegal act and independent auditors have a responsibility under SAS No. 54, *Illegal Acts by Clients* (AICPA, *Professional Standards*, vol. 1, AU sec. 317), to be aware of the possibility that illegal acts may have occurred, indirectly affecting amounts recorded in an entity's financial statements. In addition, if specific information comes to the auditor's attention that provides evidence concerning the existence of possible illegal acts that could have a material indirect effect (for example, the entity's contingent liability resulting from illegal acts committed as part of the money laundering process) on the entity's financial statements, the auditor should apply auditing procedures specifically designed to ascertain whether an illegal act has occurred.

Auditors should also note that laundered funds and their proceeds could be subject to asset seizure and forfeiture (claims) by law enforcement agencies, which could result in material contingent liabilities during prosecution and adjudication of cases.

You should refer to the Securities Industries Association Anti-Money Laundering Committee's *Preliminary Guidance For Deterring Money Laundering Activity* for additional descriptions of possible suspicious activities and a discussion of the role of the clearing broker and introducing broker. The Financial Action Task Force on Money Laundering Web site at http://www1.oecd.org/fatf/ is another good source of information to help you understand the types of activities that constitute and facilitate money laundering.

The following is a brief summary of recent anti-money laundering developments.

Customer Identification Programs

On May 9, 2003, Treasury and the SEC jointly issued a final rule to implement Section 326 of the Patriot Act. The final rule requires that broker-dealers establish, document, and maintain a written customer identification program (CIP). This program must be appropriate for the firm's size and business, be part of the firm's anti-money laundering compliance program, and, at a minimum, must contain the following four elements: (1) establishing identity verification procedures; (2) maintaining records related to CIP; (3) determining whether a customer appears on any designated list of terrorists or terrorist organizations; and (4) providing customers with notice that information is being obtained to verify their identities. The final regulation applies to all brokers or dealers in securities except for those that register with the SEC solely because they effect transactions in securities futures products. This rule became effective June 9, 2003, with compliance required by October 1, 2003. To help their members understand and implement the new rules related to CIPs, the NYSE issued Information Memo 03-32, *Customer Identification Programs for Broker-Dealers*, and the NASD issued Notice to Members 03-34, *Anti-Money Laundering Customer Identification Programs for Broker/Dealers.*

On May 9, 2003, Treasury and the Commodity Futures Trading Commission jointly issued a final rule to implement Section 326 of the Patriot Act. The final rule applies to all futures commission merchants and introducing brokers except for those that register with the CFTC solely because they effect transactions in security futures products. The requirements of this rule are similar to the requirements of the rule for broker-dealers.

On October 1, 2003, the SEC and Treasury provided guidance regarding the CIP rule and Omnibus Accounts. This information can be found on the Web at http://www.sec.gov/divisions/marketreg/qa-bdidprogram.htm.

Anti-Money Laundering Programs

Section 352 of the Patriot Act requires each financial institution, as defined in the Bank Secrecy Act (BSA), to establish an anti-money laundering (AML) program, which, at a minimum, must contain the following components: (1) development of internal policies, procedures, and controls; (2) designation of a compliance officer; (3) an ongoing employee training program; and (4) an independent audit function to test programs. In April 2002, the SEC approved NASD Rule 3011 and NYSE Rule 445, which require each member firm and member organization to have AML compliance programs in place by April 24, 2002. Among other things, the new rules require that firms independently test their AML programs. In *Notice to Members 02-21*, NASD stated that the independent tests should occur on an annual basis. Since firms were required to have their programs in place by April 24, 2002, firms should have completed such testing by April 24, 2003. NASD and NYSE advised their members that, to the extent that the initial testing has not been fully completed by that date, examiners will expect firms' programs, at a minimum, to include a definitive plan that includes a timetable for completion of the testing and the manner of testing. Many small firms are concerned about the independent testing requirement and its impact on their auditors' independence. In October 2003, Lori Richards, Director of the SEC Office of Compliance Inspections and Examinations, stated that "small firms may use internal staff as long as they are independent from the AML program itself and have the knowledge they need to effectively evaluate your firm's AML system. However, some firms may find it more cost effective to use a qualified outside party. Training internal staff and establishing procedures to ensure their independence also costs money… Some small firms have coordinated with other small firms to hire an outside auditor at a reduced group rate."

NASD offers on its Web site (http://www.nasdr.com/money.asp) an AML compliance program template for small firms to assist them in fulfilling their responsibilities to establish the AML program. The template has been recently updated to incorporate new language concerning, among other things, the final customer identification rule. The template also contains instructions, relevant rules and Web sites, and other resources that are useful for developing an AML plan for a small firm.

In October 2002, the NASD amended its Rule 3011 to require its members to identify and provide to NASD the contact information for the individual or individuals responsible for implementing and monitoring the day-to-day operations and internal controls of the member's AML compliance program. The rule became effective on October 21, 2002, and became operative on December 31, 2002. See NASD *Notice to Members 02-78* for more information.

In 2002, the CFTC approved NFA Compliance Rule 2-9(c), requiring each futures commission merchant and introducing broker member of the NFA to establish and implement an AML program. The Financial Crimes Enforcement Network had temporarily deferred application of the AML program requirement for commodity pool operators and commodity trading advisors pending the issuance of final rules for these financial institutions. However, in September 2002, FinCEN proposed a rule that will require certain unregistered investment companies, including commodity pools, to have AML programs. Because the proposed rule targets commodity pools, there may not be a need for a separate AML rule for CPOs. On May 5, 2003, FinCEN proposed rules that would require certain CTAs and securities investment advisers to have AML programs. The proposed rules cover investment advisers registered with the SEC, as well as advisers that have $30 million or more of assets under management but are not required to register with the SEC under a statutory exception for investment advisers with fewer than 15 clients who do not generally hold themselves out to the public as investment advisers.

On July 11, 2003, the SEC approved adoption of a new Municipal Securities Rulemaking Board (MSRB) Rule G-41, on anti-money laundering compliance. The MSRB adopted Rule G-41 to ensure that all brokers, dealers, and municipal securities dealers (dealers) that effect transactions in municipal securities, and in particular those that only effect transactions in municipal securities, are aware of, and in compliance with, anti-money laundering compliance program requirements. Thus, Rule G-41 requires that all dealers establish and implement AML programs that are in compliance with the rules and regulations of either their registered securities association (i.e., NASD) or the appropriate banking regulator governing the establishment and maintenance of anti-money laundering programs. The adoption of Rule G-41 will provide clarity to dealers and examiners concerning the rules and regulations that dealers who effect transactions in municipal securities must comply with concerning the development of anti-money laundering compliance programs; it will not impose any new or different obligations upon such dealers. The new rule can be found on the Web at http://ww1.msrb.org/msrb1/whatsnew/G-41approval.htm.

Suspicious Activity Reports

The final rule implementing Section 356 of the Patriot Act, requiring broker-dealers to report to the Department of the Treasury suspicious transactions that involve $5,000 or more in funds or other assets, became effective on January 1, 2003. Treasury Form SAR S-F (Suspicious Activity Report by the Securities and Futures Industries) should be used by broker-dealers and may be used voluntarily by FCMs registered with the CFTC to report suspicious activity to Treasury. Readers may wish to refer to the NASD Notice to Members No. 02-47, *Treasury Issues Final Suspicious Activity Reporting Rule for Broker/Dealers*, and NYSE Information Memo 02-64 for a discussion of this regulation and the form.

On May 5, 2003, Treasury proposed amendments to the Bank Secrecy Act Regulation that would add FCMs and IBs in commodities to the regulatory definition of financial institution, and would require that they report suspicious transactions to FinCEN. FinCEN is the policy-making and law enforcement agency within the U.S. Department of the Treasury that supports law enforcement investigative efforts and fosters interagency and global cooperation against domestic and international financial crimes.

Correspondent Accounts

On September 26, 2002, Treasury issued a final rule titled *Correspondent Accounts for Foreign Shell Banks; Recordkeeping and Termination of Correspondent Accounts for Foreign Banks* to implement Sections 313(a) and 319(b) of the Patriot Act. The new rule prohibits certain financial institutions, including broker-dealers, from providing correspondent accounts to foreign shell banks; requires such financial institutions to take reasonable steps to ensure that correspondent accounts provided to foreign banks are not being used to indirectly provide banking services to foreign shell banks; requires certain financial institutions that provide correspondent accounts to foreign banks to maintain records of the ownership of such foreign banks and their agents in the United States designated for service of legal process for records regarding the corresponding account; and requires the termination of correspondent accounts of foreign banks that fail to comply with or fail to contest a lawful request of the Secretary of the Treasury or the Attorney General of the United States.

Information Sharing

On September 26, 2002, Treasury issued a final rule to encourage information sharing among financial institutions and federal government law enforcement agencies for the purpose of identifying, preventing, and deterring money laundering and terrorist activity. Under the new rule, which implements Section 314 of the Patriot Act, certain financial institutions will be able to share information among themselves for the purpose of identifying and reporting suspected terrorism and money laundering once the financial institutions have notified FinCEN that they intend to share such information and that they will take adequate steps to maintain confidentiality. Under the final rule, any financial institution that is required to establish and maintain an anti-money laundering program or is treated as having satisfied this requirement is eligible to share information.

AICPA 2003 Audit and Accounting Guide *Brokers and Dealers in Securities*

AICPA Audit and Accounting Guide *Brokers and Dealers in Securities* (the Guide), with conforming changes as of May 1, 2003, has been updated to reflect the issuance of recently issued authoritative pronouncements. The Guide is available through the AICPA's reSOURCE Online and reSOURCE CD-ROM products, as well as through a loose-leaf subscription service. Paperback editions of Audit and Accounting Guides can be purchased as well.

> **Help Desk—**Subscriptions to AICPA reSOURCE, subscriptions to the loose-leaf service, and paperback copies of the Guide may be obtained by calling the AICPA Order Department (Member Satisfaction) at (888) 777-7077, by faxing a request to (800) 362-5066, or by going online at www.cpa2biz.com.

New Auditing and Attestation Pronouncements and Other Guidance

Presented below is a list of auditing and attestation pronouncements, guides, and other guidance issued since the publication of last year's Alert. The Public Company Accounting Oversight Board sets standards for audits of public companies. See the PCAOB Web site at www.pcaobus.org for information about PCAOB activities and any standards issued by the PCAOB. For information on auditing and attestation standards issued subsequent to the publication of this Alert, please refer to AICPA Online at www.aicpa.org/members/div/auditstd/technic.htm and to the PCAOB Web site. You may also look for announcements of newly issued standards in the *CPA Letter*, the *Journal of Accountancy*, and the quarterly electronic newsletter *In Our Opinion*, issued by the AICPA Auditing Standards Team and available at www.aicpa.org.

SAS No. 101	*Auditing Fair Value Measurements and Disclosures* Issued in January 2003. This SAS is effective for audits of financial statements for periods beginning on or after June 15, 2003. Earlier application is permitted.

(*continued*)

Audit Interpretation of SAS No. 58, *Reports on Audited Financial Statements*	Interpretation No. 16, "Effect on Auditor's Report of Omission of Schedule of Investments by Investment Partnerships That Are Exempt From Securities and Exchange Commission Registration Under the Investment Company Act of 1940" (AICPA, *Professional Standards*, vol. 1, AU sec. 9508). Published in the June 2003 *Journal of Accountancy*.
Audit Interpretation of SAS No. 31, *Evidential Matter*	Amendment of Interpretation No. 2, "The Effect of an Inability to Obtain Evidential Matter Relating to Income Tax Accruals" (AICPA, *Professional Standards*, vol. 1, AU sec. 9326). Published in the June 2003 *Journal of Accountancy.*
Audit Guide	*Audits of States, Local Governments, and Not-for-Profit Organizations Receiving Federal Awards* (with conforming changes as of May 1, 2003).
Attestation Interpretation of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (Not applicable to attest engagements on public companies)	Interpretation No. 5, "Attest Engagements on Financial Information Included in XBRL Instance Documents" (AICPA, *Professional Standards,* vol. 1, AT sec. 9101).
SOP No. 03-2 (Not applicable to attest engagements on public companies)	*Attest Engagements on Greenhouse Gas Emissions Information* Issued in September 2003.
Practice Alert No. 2003-1 (Nonauthoritative)	*Audit Confirmations*
Practice Alert No. 2003-2 (Nonauthoritative)	*Journal Entries and Other Adjustments*
Toolkit (Nonauthoritative)	*Auditing Fair Value Measurements and Disclosures: Allocations of the Purchase Price Under FASB Statement of Financial Accounting Standards No. 141*, Business Combinations, *and Tests of Impairment Under FASB Statements No. 142*, Goodwill and Other Intangible Assets, *and No. 144,* Accounting for the Impairment or Disposal of Long-Lived Assets.

(*continued*)

PCAOB Rule 3100T (Applicable to public company audits only)	This Rule generally requires all registered public accounting firms to adhere to the PCAOB's auditing and related professional practice standards in connection with the preparation or issuance of any audit report for an issuer and in their auditing and related attestation practices.
PCAOB Rule 3200T (Applicable to public company audits only)	This Rule requires that in connection with the preparation or issuance of any audit report, a registered public accounting firm, and its associated persons, shall comply with GAAS, as described in SAS No. 95, as in existence on April 16, 2003.
PCAOB Rule 3300T (Applicable to public company audits only)	This rule requires that in connection with an engagement *(i)* Standards Board's (ASB's) SSAE No. 10 and *(ii)* related to the preparation or issuance of audit reports for issuers, a registered public accounting firm, and its associated persons, shall comply with the SSAEs, and related interpretations and SOPs, as in existence on April 16, 2003.
PCAOB Rule 3400T (Applicable to public company audits only)	A registered public accounting firm, and its associated persons, shall comply with quality control standards, as described in *(a)* the AICPA ASB's Statements on Quality Control Standards, as in existence on April 16, 2003; and *(b)* the AICPA SEC Practice Section's Requirements of Membership *(d), (f)* (first sentence), *(l), (m), (n)(1)* and *(o),* as in existence on April 16, 2003.

Of the pronouncements, guides, and other guidance listed above, those having particular significance to the securities industry are briefly explained below. These summaries are for informational purposes only and should not be relied upon as a substitute for a complete reading of the applicable standard. To obtain copies of AICPA standards and guides, contact the Member Satisfaction Center at (888) 777-7077 or go online at www.cpa2biz.com.

SAS No. 101, *Auditing Fair Value Measurements and Disclosures*

As investment strategies increasingly include investing in more complex and higher-risk securities, the values of securities may not be readily available through market quotations. Such securities are often valued at amounts determined by the broker-dealers' management. Auditing the valuation of such securities is an area that requires a high degree of judgment and scrutiny to ensure that the valuation procedures are reasonable and underlying support is appropriate. SAS No. 101, *Auditing Fair Value Measurements and Disclosures* (AICPA, *Professional Standards,* vol. 1, AU sec. 328), issued in January 2003, contains significantly expanded guidance on the audit procedures for fair value measurements and disclosures. The standard is effective for audits of financial statements for periods beginning on or after June 15, 2003.

SAS No. 101 provides overall guidance on auditing fair value measurements and disclosures. Under SAS No. 101, the auditor's substantive tests of fair value measurements involve (a) testing management's significant assumptions, the valuation model, and the underlying data, (b) developing independent fair value estimates for corroborative purposes, or (c) examining subsequent events and transactions that confirm or disconfirm the estimate.

When testing management's significant assumptions, the valuation model, and the underlying data, the auditor evaluates whether:

1. Management's assumptions are reasonable and reflect, or are not inconsistent with, market information.
2. The fair value measurement was determined using an appropriate model, if applicable.
3. Management used relevant information that was reasonably available at the time.

Auditors should note that this evaluation is required even if the fair value estimate is made by a valuation specialist.

Attest Interpretation for XBRL Instance Document Engagements

The Audit Issues Task Force of the AICPA's Auditing Standards Board (ASB) has issued a new interpretation of chapter 1, "Attest Engagements," of Statement on Standards for Attestation Engagements (SSAE) No. 10, *Attestation Standards: Revision and Recodification* (AICPA, *Professional Standards*, vol. 1, AT sec. 101). The interpretation is titled *Attest Engagements on Financial Information Included in XBRL Instance Documents.* XBRL, the business reporting aspect of the Extensible Markup Language (XML), makes it possible to store or transfer data, along with complex process, data processing hierarchies and description that enable analysis and distribution. An *XBRL Instance Document* provides financial information in a machine-readable format. Through the XBRL tagging process, a mapping of the financial information is created that enables users to extract specific information, thereby facilitating analysis. The new attest interpretation defines the terms *XBRL* and *XBRL Instance Document* and describes the practitioner's considerations when he or she has been engaged to examine and report on whether an XBRL Instance Document accurately reflects certain client financial information. It also provides example examination reports. The interpretation can be found on the Web at http://www.aicpa.org/members/div/auditstd/announce/XBRL_09_16_03_FINAL.htm

New Accounting Pronouncements and Other Guidance[9]

Presented below is a list of recently issued accounting pronouncements and other guidance issued since the publication of last year's Alert. For information on accounting standards issued subsequent to the publication of this Alert, please refer to the AICPA Web site at www.aicpa.org and the FASB Web site at www.fasb.org. You may also look for announcements of newly issued standards in the *CPA Letter* and the *Journal of Accountancy*.

FASB Statement No. 148	*Accounting for Stock-Based Compensation—Transition and Disclosure*
FASB Statement No. 149	*Amendment of Statement 133 on Derivative Instruments and Hedging Activities*
FASB Statement No. 150	*Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*
FASB Interpretation No. 45	*Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*
FASB Interpretation No. 46	*Consolidation of Variable Interest Entities*

9. Readers should refer to the full text of the accounting pronouncements that are discussed in this section. Readers should also be alert for updates to the topics discussed in this section , and for other recent Financial Accounting Standards Board (FASB) and SEC developments. Further information related to FASB projects can be obtained from the FASB Web site at www.fasb.org. Further information related to SEC rules and releases can be obtained from the SEC Web site at www.sec.gov.

Discussions of the pronouncements and other guidance listed above that have particular significance to the securities industry are provided below. These summaries are for informational purposes only and should not be relied on as a substitute for a complete reading of the applicable standard.

FASB Statement No. 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*

Scope and Requirements

This Statement requires an issuer to classify the following instruments as liabilities (or assets in some circumstances):

- A financial instrument issued in the form of shares that is mandatorily redeemable—that embodies an unconditional obligation requiring the issuer to redeem it by transferring its assets at a specified or determinable date (or dates) or upon an event that is certain to occur
- A financial instrument, other than an outstanding share, that, at inception, embodies an obligation to repurchase the issuer's equity shares, or is indexed to such an obligation, and that requires or may require the issuer to settle the obligation by transferring assets (for example, a forward purchase contract or written put option on the issuer's equity shares that is to be physically settled or net cash settled)
- A financial instrument that embodies an unconditional obligation, or a financial instrument other than an outstanding share that embodies a conditional obligation, that the issuer must or may settle by issuing a variable number of its equity shares, if, at inception, the monetary value of the obligation is based solely or predominantly on any of the following:
  - A fixed monetary amount known at inception, for example, a payable settleable with a variable number of the issuer's equity shares
  - Variations in something other than the fair value of the issuer's equity shares, for example, a financial instrument

indexed to the S&P 500 and settleable with a variable number of the issuer's equity shares

– Variations inversely related to changes in the fair value of the issuer's equity shares, for example, a written put option that could be net share settled

The requirements of this Statement apply to issuers' classification and measurement of freestanding financial instruments, including those that comprise more than one option or forward contract.

This Statement does not apply to features that are embedded in a financial instrument that is not a derivative in its entirety. For example, it does not change the accounting treatment of conversion features, conditional redemption features, or other features embedded in financial instruments that are not derivatives in their entirety. It also does not affect the classification or measurement of convertible bonds, puttable stock, or other outstanding shares that are conditionally redeemable. This Statement also does not address certain financial instruments indexed partly to the issuer's equity shares and partly, but not predominantly, to something else. Financial instruments with characteristics of both liabilities and equity not addressed in this Statement will be addressed in the next phase of the project. Guidance currently in effect for those instruments continues to apply. In applying the classification provisions of this Statement, nonsubstantive or minimal features are to be disregarded.

Forward contracts to repurchase an issuer's equity shares that require physical settlement in exchange for cash are initially measured at the fair value of the shares at inception, adjusted for any consideration or unstated rights or privileges, which is the same as the amount that would be paid under the conditions specified in the contract if settlement occurred immediately. Those contracts and mandatorily redeemable financial instruments are subsequently measured at the present value of the amount to be paid at settlement (discounted at the rate implicit at inception), if both the amount of cash and the settlement date are fixed, or, otherwise, at the amount that would be paid under the conditions specified in the contract if settlement occurred at the reporting date. Other financial instruments within the scope of this Statement are initially and subsequently measured at fair value, unless required by this Statement or other generally accepted accounting principles to be measured differently. Disclosures are required about the terms of the instruments and settlement alternatives.

This Statement also addresses questions about the classification of certain financial instruments that embody obligations to issue equity shares. Previously, under EITF Issue No. 00-19, *Accounting for Derivative Financial Instruments Indexed to, and Potentially Settled in, a Company's Own Stock*, an issuer of a contract to repurchase its equity shares generally accounted for that contract as equity if the issuer must or could settle it by delivering its equity shares (net share settled). Additionally, certain obligations settleable by delivery of the issuer's equity shares but not indexed to the issuer's shares may have been classified as equity. Under this Statement, those obligations are accounted for as liabilities.

Effective Date

This Statement is effective for financial instruments entered into or modified after May 31, 2003, and otherwise is effective at the beginning of the first interim period beginning after June 15, 2003, except for mandatorily redeemable financial instruments of nonpublic entities. It is to be implemented by reporting the cumulative effect of a change in an accounting principle for financial instruments created before the issuance date of the Statement and still existing at the beginning of the interim period of adoption. Restatement is not permitted.

In November 2003, the FASB issued FSP FAS 150-3, which defers the effective date of the mandatorily redeemable provisions of FASB Statement No. 150 and all related FSPs (including FSP FAS 150-2) for nonpublic entities as follows: (a) until fiscal periods beginning after December 15, 2004 for instruments that are mandatorily redeemable on fixed dates and (b) indefinitely, pending further FASB action, if the redemption date is not fixed or if the payout amount is variable and not based on an index. It should be pointed out that the deferral for mandatorily redeemable financial instruments of certain nonpublic entities does not apply to a company that is considered to be an SEC registrant, even when it meets the definition of a nonpublic entity in FASB Statement No. 150. For example, a company that is required to file financial statements with the SEC is considered to be an SEC registrant. In this case, therefore, nonpublic brokers will not get a deferral, as they are treated as SEC registrants. You can view this and other FSPs on the FASB Web site at http://www.fasb.org/fasb_staff_positions/final_fsp.shtml.

FASB Staff Positions

The FASB has issued and proposed several FSPs related to FASB Statement No. 150 that may be of interest to securities firms and their auditors. FSPs are available on the FASB Web site at www.fasb.org.

FASB Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*

In November 2002, the FASB issued Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others*. Interpretation No. 45 requires disclosures in interim and annual financial statements about obligations under certain guarantees issued by the company. Furthermore, it requires recognition at the beginning of a guarantee of a liability for the fair value of the obligation undertaken in issuing the guarantee, with limited exceptions.

This guidance does not apply to certain guarantee contracts, such as those issued by insurance companies or for a lessee's residual value guarantee embedded in a capital lease. The provisions related to recognizing a liability at inception of the guarantee for the fair value of the guarantor's obligations would not apply to product warranties or to guarantees accounted for as derivatives.

Paragraph 13 of Interpretation No. 45 requires the guarantor to disclose the following information about each guarantee, or each group of similar guarantees, even if the likelihood of the guarantor's having to make any payments under the guarantee is remote:

a. The nature of the guarantee, including the approximate term of the guarantee, how the guarantee arose, and the events or circumstances that would require the guarantor to perform under the guarantee.

b. The maximum potential amount of future payments (undiscounted) the guarantor could be required to make under the guarantee. That maximum potential amount of future payments shall not be reduced by the effect of any amounts that may possibly be recovered under recourse or collateralization provisions in the guarantee (which are addressed under (d) below). If the terms of the guarantee provide for no limitation to the maximum potential future payments under the guarantee, that fact shall be disclosed. If the guarantor is unable to develop an estimate of the maximum potential amount of future payments under its guarantee, the guarantor shall disclose the reasons why it cannot estimate the maximum potential amount. This particular disclosure requirement is not applicable to product warranties and other guarantee contracts that are excluded from the initial recognition and initial measurement requirements. Instead, for those product warranties, the guarantor should follow disclosure requirements provided paragraph 14 of Interpretation No. 45.

c. The current carrying amount of the liability, if any, for the guarantor's obligations under the guarantee (including the amount, if any, recognized under paragraph 8 of FASB Statement No. 5), regardless of whether the guarantee is freestanding or embedded in another contract.

d. The nature of (1) any recourse provisions that would enable the guarantor to recover from third parties any of the amounts paid under the guarantee and (2) any assets held either as collateral or by third parties that, upon the occurrence of any triggering event or condition under the guarantee, the guarantor can obtain and liquidate to recover all or a portion of the amounts paid under the guarantee. The guarantor

> shall indicate, if estimable, the approximate extent to which the proceeds from liquidation of those assets would be expected to cover the maximum potential amount of future payments under the guarantee.

The initial recognition and initial measurement provisions apply on a prospective basis to guarantees issued or modified after December 31, 2002, regardless of the guarantor's fiscal year end. The disclosure requirements in the Interpretation are effective for financial statements of interim or annual periods ending after December 15, 2002.

In December 2003, the FASB issued FSP FIN 45-2, *Whether FASB Interpretation No. 45 Provides Support for Subsequently Accounting for a Guarantor's Liability at Fair Value*, which can be found of the FASB Web site.

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*[10]

FASB Interpretation No. 46, *Consolidation of Variable Interest Entities,* was issued to address consolidation by business enterprises of entities to which the usual condition of consolidation described in Accounting Research Bulletin (ARB) No. 51, *Consolidated Financial Statements*, does not apply, either because the equity investors in an entity *(a)* do not have the characteristics of a controlling financial interest, or *(b)* do not have sufficient equity at risk for the entity to finance its activities without additional subordinated financial support. An entity lacking one of these characteristics is referred to as a variable interest entity (VIE). Interpretation No. 46 governs how entities should assess interests in other entities in determining whether to consolidate (or deconsolidate) that entity. Many entities will be implementing

10. In previous exposure drafts, these entities have been referred to as special-purpose entities (SPEs). Because some entities that have been commonly referred to as SPEs may not be subject to this Interpretation, and other entities that have not been commonly referred to as SPEs may be subject to this Interpretation, the FASB decided to use the term variable interest entity.

the provisions of this Interpretation and auditors may need to ensure that they understand the requirements of Interpretation No. 46 and determine whether management is complying with those requirements.

Note that many of the entities subject to Interpretation No. 46 are commonly referred to as special purpose entities (SPEs), but some are not. In addition, some SPEs may not be subject to Interpretation No. 46.

Every Relationship Should Be Assessed

Interpretation No. 46 requires an assessment of every relationship between an enterprise and another legal entity. Legal entities include grantor trusts, limited liability corporations, partnerships, corporations, and other trusts. Broadly stated, an entity that must determine consolidation in accordance with Interpretation No. 46 is known as a VIE and an entity that is required to consolidate a VIE is known as a primary beneficiary.

Scope Exclusions

Interpretation No. 46 excludes from its scope the following entities:

- Not-for-profit organizations
- Employee benefit plans
- Registered investment companies
- Transferors to and holders of a variable interest in a qualified special-purpose entity (QSPE), as defined by FASB Statement No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*
- Separate accounts of life insurance companies

Related FASB Literature

Interpretation No. 46 nullifies portions or all of EITF Issue No. 90-15, *Impact of Nonsubstantive Lessors, Residual Value Guarantees and Other Provisions in Leasing Transactions*, and EITF Issue No. 96-21, *Implementation Issues in Accounting for Leasing Transactions Involving Special Purpose Entities*. Standards for capitalization such as 3 percent minimum equity no longer apply when voting interest entities are involved. The provisions of Interpretation No. 46 govern when a variable interest must be analyzed. Additionally, the FASB recently issued a total of seven FSPs on applying various provisions of Interpretation No. 46; these can be found at www.fasb.org/fasb_staff_positions/final_fsp.shtml. Also, Interpretation No. 45, *Guarantor's Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness to Others*, should be used in conjunction with Interpretation No. 46 when analyzing off-balance-sheet financings.

New Proposed Interpretation

The FASB has issued an exposure draft of a proposed modification of Interpretation No. 46. The exposure draft addresses 17 modifications to the Interpretation in an attempt to clarify the guidance, provide certain limited-scope exceptions, and provide for more consistent application. The exposure draft can be obtained at www.fasb.org/draft/.

Audit Considerations

Accurately applying the guidance in Interpretation No. 46 can be challenging. Determining whether an entity is a VIE, identifying the primary beneficiary, and computing an entity's expected losses and expected residual returns can be difficult and may rely heavily on the use of management judgment. Depending on the circumstances, auditors may need to gain a solid understanding of Interpretation No. 46 and engage specialists if the need arises.

Also, auditors need to be aware that primary beneficiaries will need audited financial statements of the VIE for consolidation. One should plan for the audits of potential entities as early as possible, since evaluating such items as historical information and deciding which investor will bear the additional cost of the audit is instrumental and may be difficult to negotiate in practice.

Deferral of Implementation Date

FSP FIN 46-6 defers to the fourth quarter of 2003 from the third quarter the implementation date for Interpretation No. 46. This deferral only applies to VIEs that existed prior to February 1, 2003. The complete text of FSP FIN 46-6 can be found on the FASB Web site.

On the Horizon

Auditors should keep abreast of auditing and accounting developments and upcoming guidance that may affect their engagements. Auditors of public companies should keep abreast of standards and rules issued by the PCAOB. The AICPA general *Audit Risk Alert—2003/04* (product no. 022334kk) summarizes some of the more significant ongoing projects and exposure drafts outstanding. Remember that exposure drafts are nonauthoritative and cannot be used as a basis for changing GAAP or GAAS.

The following table lists the various standard-setting bodies' Web sites where information may be obtained on outstanding exposure drafts and where copies of exposure drafts may be downloaded. These Web sites contain much more in-depth information about proposed standards and other projects in the pipeline. Many more accounting and auditing projects exist beyond those discussed below. Readers should refer to information provided by the various standard-setting bodies for further information.

Standard-Setting Body	*Web Site*
AICPA Auditing Standards Board (ASB)	www.aicpa.org/members/div/auditstd/drafts.htm
AICPA Accounting Standards Executive Committee (AcSEC)	www.aicpa.org/members/div/acctstd/edo/index.htm
Financial Accounting Standards Board (FASB)	www.rutgers.edu/Accounting/raw/fasb/draft/draftpg.html
Professional Ethics Executive Committee (PEEC)	www.aicpa.org/members/div/ethics/index.htm
Public Company Accounting Oversight Board (PCAOB)	www.pcaobus.org

Help Desk—The AICPA's standard-setting committees publish exposure drafts of proposed professional standards exclusively on the AICPA Web site. The AICPA will notify interested parties by e-mail about new exposure drafts. To be added to the notification list for all AICPA exposure drafts, send your e-mail address to memsat@aicpa.org. Indicate "exposure draft e-mail list" in the subject header field to help process your submission more efficiently. Include your full name, mailing address, and, if known, your membership and subscriber number in the message.

New Framework for the Audit Process (This discussion does not apply to the audits of public companies)

The ASB is reviewing the auditor's consideration of the risk assessment process in the auditing standards, including the necessary understanding of the client's business and the relationships among inherent, control, fraud, and other risks. The ASB issued a series of exposure drafts in early 2003. Some participants in the process expect the final standards to have an effect on the conduct of audits that has not been seen since the "Expectation Gap" standards were issued in 1988.

Some of the more important changes to the standards that have been proposed are the following:

- A requirement for a more robust understanding of the entity's business and environment that is more clearly linked to the assessment of the risk of material misstatement of the financial statements. (Among other things, this will improve the auditor's assessment of inherent and control risks and eliminate the "default" to assess these risks at the maximum.)
- An increased emphasis on the importance of entity controls with clearer guidance on what constitutes sufficient knowledge of controls to plan the audit.
- A clarification of how the auditor may obtain evidence about the effectiveness of controls in obtaining an understanding of controls.

- A clarification of how the auditor plans and performs auditing procedures differently for higher and lower assessed risks of material misstatement at the assertion level while retaining a "safety net" of procedures.

These changes collectively are intended to improve the guidance on how the auditor operationalizes the audit risk model.

You should keep abreast of the status of these projects and projected exposure drafts, inasmuch as they will substantially affect the audit process. More information can be obtained on the AICPA's Web site at www.aicpa.org.

Resource Central

On the Bookshelf

The following AICPA publications deliver valuable guidance and practical assistance as potent tools to be used in your engagements:

- Audit and Accounting Guide *Brokers and Dealers in Securities* (product no. 012703kk)
- Audit Guide *Auditing Derivative Instruments, Hedging Activities, and Investments in Securities* (product no. 012520kk)
- Audit Guide *Auditing Revenue in Certain Industries* (product no. 012510kk)
- Audit Guide *Audit Sampling* (product no. 012530kk)
- Audit Guide *Analytical Procedures* (product no. 012551kk)
- Audit Guide *Service Organizations: Applying SAS No. 70, As Amended* (product no. 012772kk)
- Practice Aid *Auditing Estimates and Other Soft Accounting Information* (product no. 010010kk)
- *Accounting Trends & Techniques—2003* (product no. 009895kk)

- Practice Aid *Preparing and Reporting on Cash- and Tax-Basis Financial Statements* (product no. 006701kk)
- Practice Aid *Fraud Detection in a GAAS Audit* (product no. 006613kk)

AICPA Practice Aid *Audits of Futures Commission Merchants, Introducing Brokers, and Commodity Pools*

This Practice Aid (product no. 006600kk) provides practitioners with nonauthoritative practical guidance on auditing financial statements of futures commission merchants, introducing brokers, and commodity pools. Organized to complement the Audit and Accounting Guide *Brokers and Dealers in Securities*, this Practice Aid includes an overview of the commodity industry; discussions of regulatory considerations, auditing considerations, and accounting standards; and illustrative financial statements of FCMs, IBs, and commodity pools.

Audit and Accounting Manual

The *Audit and Accounting Manual* (product no. 005133kk) is a valuable nonauthoritative practice tool designed to provide assistance for audit, review, and compilation engagements. It contains numerous practice aids, samples, and illustrations, including audit programs, auditor's reports, checklists, engagement letters, management representation letters, and confirmation letters.

AICPA reSOURCE Online: Accounting and Auditing Literature

Get access—anytime, anywhere—to the AICPA's latest *Professional Standards, Technical Practice Aids*, Audit and Accounting Guides, Audit Risk Alerts, and *Accounting Trends & Techniques.* To subscribe to this essential online service, go to cpa2biz.com.

Educational Courses

The AICPA has developed a number of continuing professional education (CPE) courses that are valuable to CPAs working in public practice and industry. Those courses include:

- *AICPA's Annual Accounting and Auditing Update Workshop* (product no. 737186kk [text], 187086kk [VHS tape/manual], and 187186kk [DVD]). Whether you are in industry or public practice, this course keeps you current and informed, and shows you how to apply the most recent standards.
- *Fraud and the Financial Statement Audit: Auditor Responsibilities Under New SAS* (product no. 731810kk [text] and 181810kk [video]). The new fraud standard may not change your responsibilities for detecting fraud in a financial statement audit, but it will change how you meet that responsibility. Practitioners will benefit from a risk assessment approach to detecting fraud in a financial statement audit. You will learn the conceptual framework necessary to understand the characteristics of fraud.
- *Auditing for Internal Fraud* (product no. 730237kk). This course provides the auditor with the tools to identify fraud schemes. It trains CPAs to focus their analytical and substantive tests on the fraud triangle when evaluating internal controls. It also illustrates the latest in fraud prevention and detection programs implemented by industry leaders.
- *Identifying Fraudulent Financial Transactions* (product no. 730244kk). Learn to identify the red flags of fraud in financial information and to analyze a variety of fraud schemes. You will develop a framework for detecting financial statement fraud and learn about fraud schemes in revenue, inventory, liabilities, and assets.
- *Independence* (product no. 739155kk). This interactive CD-ROM course reviews the AICPA authoritative literature covering independence standards (including the AICPA SEC practice section independence requirements), SEC regulations on independence, and Independence Standards Board (ISB) standards.
- *SEC Reporting* (product no. 186748kk [VHS tape/manual] and 736749kk [text]). This course helps the practicing CPA and corporate financial officer learn to

apply SEC reporting requirements. It clarifies the more important and difficult disclosure requirements.

- *E-Commerce: Controls and Audit* (product no. 731551kk). This course is a comprehensive overview of the world of e-commerce. Topics covered include internal control evaluation and audit procedures necessary for evaluating business-to-consumer and business-to-business transactions.

Online CPE

AICPA InfoBytes, offered exclusively through CPA2Biz.com, is AICPA's flagship online learning product. Selected as one of *Accounting Today's* top 100 products for 2003, AICPA InfoBytes now offers a free trial subscription to the entire product for up to 30 days. AICPA members pay $149 ($369 nonmembers) for a new subscription and $119 ($319 nonmembers) for the annual renewal. Divided into one- and two-credit courses that are available 24/7, AICPA InfoBytes offers hundreds of hours of learning in a wide variety of topics. To register or learn more, visit www.cpa2biz.com/infobytes.

CPE CD-ROM

AICPA's Standards Update and Implementation Guide (product no. 738460kk) CD-ROM helps you keep on top of the latest standards. Issued twice a year, this cutting-edge course focuses primarily on new pronouncements that will become effective during the upcoming audit cycle.

National Securities Industry Conference

Each year, the AICPA cosponsors with the Financial Management Division of the Securities Industry Association the National Conference on the Securities Industry, which is specifically designed to update auditors and securities industry financial executives on significant accounting, legal, financial, and tax developments affecting the securities industry. Information on the conference may be obtained by calling the AICPA CPE Conference Hotline at (888) 777-7077 or visiting the AICPA Web site at www.aicpa.org.

Member Satisfaction Center

To order AICPA products, receive information about AICPA activities, and find help on your membership questions, call the AICPA Member Satisfaction Center at (888) 777-7077.

Hotlines

Accounting and Auditing Technical Hotline

The AICPA Technical Hotline answers members' inquiries about accounting, auditing, attestation, compilation, and review services. Call (888) 777-7077.

Ethics Hotline

Members of the AICPA's Professional Ethics Team answer inquiries concerning independence and other behavioral issues related to the application of the AICPA Code of Professional Conduct. Call (888) 777-7077.

Web Sites

AICPA Online and CPA2Biz

AICPA Online, at www.aicpa.org, offers CPAs the unique opportunity to stay abreast of matters relevant to the CPA profession. AICPA Online informs you of developments in the accounting and auditing world as well as developments in congressional and political affairs affecting CPAs. In addition, www.cpa2biz.com offers all the latest AICPA products, including the Audit Risk Alerts, Audit and Accounting Guides, the professional standards, and CPE courses.

Other Helpful Web Sites

Further information on matters addressed in this Audit Risk Alert is available through various publications and services offered by a number of organizations. Some of those organizations are listed in the "Information Sources" table at the end of this Alert.

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This Audit Risk Alert replaces *Securities Industry Developments—2002/03*. The Securities Industry Developments Audit Risk Alert is published annually. As you encounter audit or industry issues that you believe warrant discussion in next year's Alert, please feel free to share them with us. Any other comments that you have about the Alert would also be appreciated. You may e-mail these comments to ymishkevich@aicpa.org, or write to:

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INFORMATION SOURCES

Organization	*Web Site, Address, Telephone*
American Institute of Certified Public Accountants	www.aicpa.org Harborside Financial Center 201 Plaza Three Jersey City, NJ 07311-3881 Telephone: (888) 777-707
Financial Accounting Standards Board	www.fasb.org Order Department: 401 Merritt 7 P.O. Box 5116 Norwalk, CT 06856-5116 Telephone: (203) 847-0700
Financial Crimes Enforcement Network (FinCEN)	www.treas.gov/fincen
U.S. Securities and Exchange Commission	www.sec.gov Publications Unit: 450 Fifth Street, NW Washington, DC 20549-0001 Telephone: (202) 942-4040 Public Reference Room: Telephone: (202) 942-8090 (202) 942-8092 (tty)
Securities Industry Association	www.sia.com 120 Broadway, 35th floor New York, NY 10271-0080 Telephone: (212) 608-1500
New York Stock Exchange, Inc.	www.nyse.com 11 Wall Street New York, NY 10005 Telephone: (212) 656-3000
National Association of Securities Dealers, Inc.	www.nasd.com 1735 K Street, NW Washington, DC 20006-1500 Telephone: (202) 728-8000
The Bond Market Association	www.bondmarkets.com 360 Madison Avenue New York, NY 10017-7111 Telephone: (646) 637-9200

Commodity Futures Trading Commission	www.cftc.gov Three Lafayette Center 1155 21st Street, NW Washington, DC 20581 Telephone: (202) 418-5000
Futures Industry Association	www.futuresindustry.org 2001 Pennsylvania Avenue, NW Suite 600 Washington, DC 20006 Telephone: (202) 466-5460
National Futures Association	www.nfa.futures.org 200 West Madison Street Chicago, IL 60606 Telephone: (800) 621-3570